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**TECHNICAL
PRACTICE AIDS**

June 1, 1987

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**TECHNICAL
PRACTICE AIDS**

**Technical Information Service
Inquiries & Replies**

**Statements of Position
Accounting Standards Division
Auditing Standards Division**

**Issues Papers
Accounting Standards Division**

As of June 1, 1987



**AICPA 100
A CENTURY OF PROGRESS
IN ACCOUNTING
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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

TECHNICAL PRACTICE AIDS

**Technical Information Service
Inquiries & Replies**

**Statements of Position
Accounting Standards Division
Auditing Standards Division**

**Issues Papers
Accounting Standards Division**

As of June 1, 1987

Edited by:
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Technical Information Division

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TABLE OF CONTENTS

Section		Page
...	How to Use This Volume	1
	TECHNICAL INFORMATION SERVICE INQUIRIES AND REPLIES	
....	Introduction	11
1000	Financial Statement Presentation	101
	1100 Statement of Financial Position	
	1200 Income Statement	
	1300 Statement of Changes in Financial Position	
	1400 Consolidated Financial Statements	
	1500 Cash Basis Statements or Modifications Hav- ing Substantial Support	
	1600 Personal Financial Statements	
	1700 Prospective Financial Statements	
2000	Assets	701
	2100 Current Assets	
	2110 Cash	
	2120 Temporary Investments	
	2130 Receivables	
	2140 Inventories	
	2200 Noncurrent Assets	
	2210 Fixed Assets	
	2220 Long-Term Investments	
	2230 Noncurrent Receivables	
	2240 Cash Surrender Value of Life Insurance	
	2250 Intangible Assets	
	2260 Other Assets	
3000	Liabilities and Deferred Credits	1801
	3100 Current Liabilities	
	3200 Long-Term Debt	
	3400 Contingent Liabilities	
	3500 Commitments	
	3600 Deferred Credits	
4000	Capital	3001
	4100 Capital Stock	
	4110 Issuance of Capital Stock	

<i>Section</i>		<i>Page</i>
4000	Capital—Continued	
	4120 Reacquisition of Capital Stock	
	4130 Warrants	
	4140 Stock Options and Stock Purchase Plans	
	4150 Stock Dividends and Stock Splits	
	4160 Contributed Capital	
	4200 Retained Earnings	
	4210 Dividends	
	4220 Quasi-reorganizations	
	4230 Capital Transactions	
5000	Revenue and Expense	3901
	5100 Revenue Recognition	
	5200 Expenses	
	5210 Depreciation and Depletion	
	5220 Interest Expense	
	5230 Employee Benefit Plans	
	5240 Cost Allocation	
	5250 Tax Allocation	
	5260 Estimated Losses	
	5290 Other Expenses	
	5300 Prior Period Adjustments	
	5400 Extraordinary Items	
	5500 Earnings Per Share	
	5600 Leases	
6000	Specialized Industry Problems	5151
	6100 Banks	
	6110 Savings and Loan Associations	
	6120 Credit Unions	
	6130 Finance Companies	
	6200 Regulated Industries	
	6300 Insurance Companies	
	6400 Hospitals	
	6410 Nursing Homes	
	6500 Extractive Industries	
	6600 Real Estate	
	6610 Retail Land Sales Companies	
	6700 Construction Contractors	
	6900 Other Specialized Industries	
	6910 Investment Companies	
	6920 Voluntary Health and Welfare Organizations	

Section		Page
6000	Specialized Industry Problems—Continued	
	6930 Employee Health and Welfare Benefit Plans	
	6935 Profit Sharing and Pension Plans	
	6940 Franchisors	
	6950 State and Local Governmental Units	
	6955 Single Audit Act of 1984	
	6960 Colleges and Universities	
	6970 Entertainment Industry	
	6980 Brokers and Dealers	
7000	Specialized Organizational Problems	7001
	7100 Proprietorships	
	7200 Partnerships	
	7300 Not-For-Profit Organizations	
	7400 Related Parties	
	7500 Estates and Trusts	
	7600 Business Combinations—General	
	7610 Purchase Method	
	7620 Applicability of Pooling of Interests Method	
	7630 Application of Pooling of Interests Method	
	7900 Other Specialized Organizational Problems	
	7910 S Corporations	
	7920 Domestic International Sales Corporations	
8000	Audit Field Work	8301
	8100 Planning and Supervision	
	8200 Internal Control	
	8210 Statistical Sampling	
	8220 Sampling	
	8300 Evidential Matter	
	8310 Evidential Matter: Securities	
	8320 Evidential Matter: Inventories	
	8330 Evidential Matter: Fixed Assets	
	8340 Evidential Matter: Confirmation Procedures	
	8900 Other Auditing Procedures	
9000	Auditors' Reports	9301
	9100 Conformity With Generally Accepted Accounting Principles	
	9110 Compliance Reports	
	9200 Consistency	
	9210 Accounting Changes	
	9300 Disclosure	

Section		Page
9000	Auditors' Reports—Continued	
	9310 Errors and Irregularities	
	9320 Uncertainties	
	9330 Subsequent Events	
	9390 Other Disclosure Requirements	
	9410 Audited Financial Statements	
	9420 Unaudited Financial Statements of Public Entities	
	9430 Signing and Dating Reports	
	9510 Special Reports	
	9520 Reliance on Others	
	9530 Limited Scope Engagements	
	9540 Pro Forma Financial Statements	
	9600 Compilation and Review Engagements	
	9900 Other Reporting Problems	
....	Appendixes	15,001
....	Topical Index	15,401
STATEMENTS OF POSITION ACCOUNTING STANDARDS DIVISION		
...	Introduction	16,001
10,000	Statements of Position	16,501
	[10,010] Recognition of Profit on Sales of Receivables With Recourse (SOP 74-6)	
	10,020 Financial Accounting and Reporting by Col- leges and Universities (SOP 74-8)	
	10,030 Financial Accounting and Reporting by Face- Amount Certificate Companies (SOP 74-11)	
	[10,040] Accounting Practices in the Mortgage Bank- ing Industry (SOP 74-12)	
	[10,050] Revenue Recognition When Right of Return Exists (SOP 75-1)	
	10,060 Accounting Practices of Real Estate Invest- ment Trusts (SOP 75-2)	
	[10,070] Accrual of Revenues and Expenditures by State and Local Governmental Units (SOP 75-3)	
	[10,080] Presentation and Disclosure of Financial Forecasts (SOP 75-4)	
	[10,090] Accounting Practices in the Broadcasting In- dustry (SOP 75-5)	
	[10,100] Questions Concerning Profit Recognition on Sales of Real Estate (SOP 75-6)	

Section		Page
10,000	Statements of Position—Continued	
	[10,110] Accounting Practices in the Record and Music Industry (SOP 76-1)	
	[10,120] Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry (SOP 76-2)	
	10,130 Accounting Practices for Certain Employee Stock Ownership Plans (SOP 76-3)	
	10,140 Financial Accounting and Reporting by Investment Companies (SOP 77-1)	
	[10,150] Accounting for Interfund Transfers of State and Local Governmental Units (SOP 77-2)	
	10,160 Accounting by Hospitals for Certain Marketable Equity Securities (SOP 78-1)	
	10,170 Accounting Practices of Real Estate Investment Trusts (SOP 78-2)	
	[10,180] Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects (SOP 78-3)	
	[10,190] Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate (SOP 78-4)	
	[10,200] Accounting for Advance Refunding of Tax-Exempt Debt (SOP 78-5)	
	[10,210] Accounting for Property and Liability Insurance Companies (SOP 78-6)	
	[10,220] Financial Accounting and Reporting by Hospitals Operated by a Governmental Unit (SOP 78-7)	
	[10,230] Accounting for Product Financing Arrangements (SOP 78-8)	
	10,240 Accounting for Investments in Real Estate Ventures (SOP 78-9)	
	10,250 Accounting Principles and Reporting Practices for Certain Nonprofit Organizations (SOP 78-10)	
	10,260 Accounting for Municipal Bond Funds (SOP 79-1)	
	[10,270] Accounting by Cable Television Companies (SOP 79-2)	
	[10,280] Accounting for Investments of Stock Life Insurance Companies (SOP 79-3)	
	[10,290] Accounting for Motion Picture Films (SOP 79-4)	
	[10,300] Accounting for Title Insurance Companies (SOP 80-1)	

<i>Section</i>		<i>Page</i>
10,000	Statements of Position—Continued	
	[10,310] Accounting and Financial Reporting by Governmental Units (SOP 80-2)	
	[10,320] Accounting for Real Estate Acquisition, Development, and Construction Costs (SOP 80-3)	
	10,330 Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1)	
	10,340 Reporting Practices Concerning Hospital-Related Organizations (SOP 81-2)	
	10,350 Accounting and Financial Reporting for Personal Financial Statements (SOP 82-1)	
	10,360 Reporting by Banks of Investment Securities Gains or Losses (SOP 83-1)	
	10,370 Financial Reporting by Not-for-Profit Health Care Entities for Tax-Exempt Debt and Certain Funds Whose Use Is Limited (SOP 85-1)	
	10,380 Accounting for Dollar Repurchase—Dollar Reverse Repurchase Agreements by Sellers-Borrowers (SOP 85-2)	
	10,390 Accounting by Agricultural Producers and Agricultural Cooperatives (SOP 85-3)	
	10,400 Reporting Repurchase—Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations (SOP 86-1)	
	10,410 Accounting for Asserted and Unasserted Medical Malpractice Claims of Health Care Providers and Related Issues (SOP 87-1)	
	Topical Index	30,051
	STATEMENTS OF POSITION AUDITING STANDARDS DIVISION	
	Introduction	30,201
11,000	Statements of Position	30,211
	11,010 Revision of Form of Auditors' Report (7/74)	
	[11,020] Audits of Brokers and Dealers in Securities (12/76)	
	11,030 Clarification of Accounting, Auditing and Reporting Practices Relating to Hospital Malpractice Loss Contingencies (3/78)	
	11,040 Confirmation of Insurance Policies in Force (8/78)	

<i>Section</i>		<i>Page</i>
11,000	Statements of Position—Continued	
	[11,050] Report on a Financial Feasibility Study (10/82)	
	11,060 Auditing Property and Liability Reinsurance (10/82)	
	11,070 Auditing Life Reinsurance (11/84)	
	ISSUES PAPERS	
	ACCOUNTING STANDARDS DIVISION	
15,000	Listing of Issues Papers	30,701

HOW TO USE THIS VOLUME

Scope of the Volume . . .

This volume, which is a reprint of the looseleaf edition of *Technical Practice Aids*, includes selected Technical Information Service Inquiries and Replies, Statements of Position of the Accounting Standards Division, Statements of Position of the Auditing Standards Division 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:

Technical Information Service Inquiries and Replies

Introduction—Technical Hotline

Financial Statement Presentation

Assets

Liabilities and Deferred Credits

Capital

Revenue and Expense

Specialized Industry Problems

Specialized Organizational Problems

Audit Field Work

Auditors' Reports

Statements of Position of the Accounting Standards Division

Statements of Position of the Auditing Standards Division

Issues Papers of the Accounting Standards Division

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 Inquiries and Replies, within each section, each Inquiry and Reply is decimally numbered. For example, section 1200.02, Disposal of a Segment of a Business, is the second Inquiry and Reply in section 1200. When an Inquiry and Reply is deleted, its number is reserved.

The TIS Appendixes provide cross references from the pronouncements of the American Institute of Certified Public Accountants, the

Securities and Exchange Commission, the Financial Accounting Standards Board, the Governmental Accounting Standards Board, and National Council on Governmental Accounting to the Inquiries and Replies included in this volume.

The TIS topical index for the Inquiries and Replies 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 of the Accounting Standards Division 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 of the Accounting Standards Division facilitates reference to the Statements. This index is arranged alphabetically by subject, with references to section and paragraph numbers.

Statements of Position of the Auditing Standards Division 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.

TECHNICAL INFORMATION SERVICE

INQUIRIES AND REPLIES

Introduction

The inquiries and replies in this section of the AICPA TECHNICAL PRACTICE AIDS are based on selected practice problems answered by the staff of the Technical Information Service.

The sole responsibility for the material contained in this section rests with the staff of the Technical Information Service. This material has not been approved, disapproved, or otherwise acted upon by the senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board. Comments and suggestions should be addressed to:

Technical Information Division
AICPA
1211 Avenue of the Americas
New York, NY 10036

As a matter of Institute policy, the Technical Information Service staff does not undertake to give opinions on the tax or legal aspects of questions submitted.

The following disclaimer applies to all Technical Information Service replies, whether written or oral, and to the material in this section:

Views expressed by the Technical Information Service *are not official* opinions of the Institute or any of its committees, unless so indicated. Comments of the Technical Information Service staff must be accepted as the personal views of the individuals who offer them. Efforts are made to offer reliable and helpful replies to inquiries presented, and accordingly, the Service consults available authoritative sources to the extent that time and work-load permit. The Service's suggestions are based solely on the facts presented to it, and are applicable only if the circumstances are not changed.

John Graves, Director, Technical Information Division

Thomas W. McRae, Vice President—Technical

Thomas P. Kelley, Group Vice President—Professional

AICPA TECHNICAL HOTLINE

The Technical Information Service answers inquiries about specific audit or accounting problems.

Call Toll Free

(800) 223-4158 (except New York)

(800) 522-5430 (New York only)

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TIS Section 1000

FINANCIAL STATEMENT PRESENTATION

TABLE OF CONTENTS

Section

1100 Statement of Financial Position

- .01 Need for Comparative Financial Statements
- .02 Classification of Assets and Liabilities as Current and Noncurrent [Amended]
- .03 Unclassified Balance Sheet for Venture with Limited Life
- [.04] Reserved
- [.05] Reserved
- .06 Classification of Idle Property
- .07 Comparative Statement Disclosures
- .08 Classification of Outstanding Checks
- [.09] Reserved
- [.10] Reserved
- .11 Offsetting Assets and Liabilities
- .12 Classification of Inventory Stored in a Grain Elevator
- .13 Use of an Unclassified Balance Sheet by a Leasing Company

1200 Income Statement

- .01 Disclosure of Revenues of an Agent
- .02 Disposal of a Segment of a Business
- .03 Discontinued Operations—Decision Reversed
- .04 Statement Title When There Is a Net Loss

1300 Statement of Changes in Financial Position

- .01 Title of Funds Statement
- .02 Title of Funds Statement When Fund Is Cash
- .03 Comparative Statements of Changes in Financial Position
- .04 Elements of Working Capital [Amended]
- .05 Statement of Changes in Financial Position for Annual Report with Balance Sheet Only
- .06 Format of Statement of Changes in Financial Position when Operations Result in an Application of Funds

Section**1300 Statement of Changes in Financial Position—Continued**

- .07 Statements of Changes in Financial Position for Nonprofit Organizations [Amended]
- .08 Effect of Change in Depreciation Method on Statement of Changes in Financial Position
- .09 Presentation of Property Sold in Statement of Changes in Financial Position
- .10 Comprehensive Basis of Accounting Other than Generally Accepted Accounting Principles
- .11 The Effect of a Prior Period Adjustment on the Statement of Changes in Financial Position When Single Period Statements Are Presented

1400 Consolidated Financial Statements

- .01 Operations of Subsidiaries and Parent Closely Related [Amended]
- .02 Consolidation of Corporation and Proprietorship
- [.03] Reserved
- [.04] Reserved
- .05 Accounting for Investments on Unconsolidated Statements Issued as Supplements to Consolidated Statements
- .06 Combined and Separate Financial Statements
- .07 Reporting on Company Where Option to Acquire Control Exists
- .08 Intercompany Profits in Inventories
- .09 Intercompany Profit on Sale of Receivables [Amended]
- [.10] Reserved
- [.11] Reserved
- [.12] Reserved
- .13 Presentation of Investment in Partnership
- .14 Consolidation of Indirect Subsidiaries
- .15 Temporary Loss of Control of Subsidiary
- [.16] Reserved
- .17 Caption of Notes to Financial Statements [Amended]
- .18 Combined Statements for Corporation and Partnership Commonly Owned
- .19 Consolidation of Limited Partnerships
- .20 Fiscal Years for Tax and Financial Reporting Purposes Differ
- .21 Minority Interest Guarantee [Amended]
- .22 Intervening Intercompany Transactions Between Subsidiary's and Parent's Year End
- .23 Conforming Subsidiary's Inventory Pricing Method to Its Parent's Method
- .24 Classification of Minority Interest

Section**1500 Cash Basis Statements or Modifications Having Substantial Support**

- [.01] Reserved**
- [.02] Reserved**
- .03 Presentation of Income Tax Expense in Cash Basis Financial Statements**
- .04 Terminology for Cash Basis Financial Statements**
- .05 Substantial Support for Modifications in Cash Basis**

1600 Personal Financial Statements

- .01 Applicability of FASB Statement No. 12 to Personal Holding Companies**
- .02 Income Tax Provision Related to Estimated Current Value of Personal Residence Disclosed in Personal Financial Statements**

1700 Prospective Financial Statements

- .01 Omission of a Minimum Guideline in a Prospective Financial Statement**
-

➡ The next page is 121. ←

Section 1100

Statement of Financial Position

.01 Need for Comparative Financial Statements

Inquiry—Are both a balance sheet and income statement (and, therefore, also the funds statement) required for all annual reports, and must all such statements be in comparative form for at least two years?

Is either statement alone a fair presentation? There are certain specific circumstances where this question can be specifically raised, for example, does a balance sheet alone (especially if not in comparative form) “fairly present” financial position if the client incurred a material operating loss during the current year?

Reply—ARB No. 43, chapter 2A, paragraph 2, recommends, but does not require, presentation of comparative financial statements. However, by its Securities and Exchange Act of 1934 Release No. 9000, the SEC requires comparative financial statements for the last two fiscal years, both in financial statements submitted to it and, under its proxy regulations, in annual reports of such companies to the public.

SAS No. 2, paragraph 5, states:

Reference in the fourth reporting standard to the financial statements “taken as a whole” applies equally to a complete set of financial statements and to an individual financial statement, for example, to a balance sheet. 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 call for this treatment.

SAS No. 2, paragraph 13, states:

The auditor may be asked to report on one basic financial statement and not on the others. For example, he may be asked to report on the balance sheet and not on the statements of income, retained earnings or changes in financial position. These engagements do not involve scope limitations if the auditor’s access to information underlying the basic financial statements is not limited and if he applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

Therefore, it appears a separate statement of financial position may fairly present financial position, and a separate statement of income may fairly present results of operations for a period. Such statements are useful for certain purposes, such as in statements furnished to indicate compliance with bond indentures and reports on operations for an interim period. The fact that many users of financial statements will require a statement of financial position, a statement of income, a statement of changes in stockholders' equity, and a statement of changes in financial position to properly evaluate a company does not indicate that a single statement may not fairly present the information it purports to present.

A statement of financial position, as the term is generally used, refers to a "picture" of an entity at one point in time. Losses from operations should be appropriately reflected in the retained earnings account of the entity. If the losses are so great that the "going concern" premise is in question, proper treatment of this matter is necessary for the statement to reflect "financial position," whether or not an accompanying statement of income is presented.

Each statement should stand on its own when presented in conjunction with the other, and therefore should be able to stand on its own when presented separately. The fact that neither statement by itself is adequate for full evaluation of the company should not preclude issuance of such statements, as they may serve other purposes.

.02 Classification of Assets and Liabilities as Current and Non-current

Inquiry—The statement of financial position of a securities broker does not distinguish assets and liabilities between current and noncurrent. Is this acceptable?

Reply—Yes. The AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, states on page 39:

Current and noncurrent classifications ordinarily are not presented on the statement of financial condition. Such a distinction normally has little meaning for brokers and dealers.

[Amended]

.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

Inquiry—What is the appropriate balance sheet presentation of idle property?

Reply—Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*, page 257, states:

Plant assets on the balance sheet may include property in use and property held with reasonable expectation of its being used in the business. It is not customary to segregate or indicate the existence of temporarily idle plant, reserve, or standby equipment. Property abandoned but not physically retired and facilities still owned but no longer adapted for use in the business, if material in amount, should be removed from plant accounts and recorded separately at an estimated realizable amount, appropriately explained.

When a material portion of plant and equipment has been idle for a protracted period with no apparent likelihood of resuming operations, the amount should be set forth separately with an appropriate caption. Such idle plant facilities involve a continuing expense, and creditors, stockholders, and others interested should be apprised of the fact that property, plant, and equipment exceed apparent reasonable needs.

.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.

.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.

.11 Offsetting Assets and Liabilities

Inquiry—When may assets and liabilities be appropriately offset?

Reply—APB Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7-1, 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."

.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, 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. Footnote disclosure should be made of the amount of grain stored for others.

.13 Use of an Unclassified Balance Sheet by a Leasing Company

Inquiry—A leasing company's balance sheet consists of cash,

rental machinery and equipment, accounts payable, accrued expenses (related to the operation of the rental equipment) and an immaterial amount of debt related to the acquisition of the rental equipment.

Would it be appropriate for the leasing company to change its balance sheet presentation from a classified balance sheet to an unclassified balance sheet? What effect would this new presentation have on the auditor's report?

Reply—For some enterprises in specialized industries unclassified balance sheets may be presented if a classified balance sheet would suggest inappropriate financial ratios. An unclassified balance sheet may be the most useful presentation for a leasing company.

A change from a classified to an unclassified balance sheet presentation is not considered a change in accounting principle. SAS No. 1, section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph 14, states that material changes of classifications in the current financial statements should be indicated and explained in the financial statements or notes to the financial statements. These types of changes and material reclassification made in previously issued financial statements to enhance comparability would not affect the auditor's opinion as to consistency and need not be referred to in the auditor's report.

➡ *The next page is 161.* ←

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	\$20,000
or	
Sales	\$ 300,000
Cost of Sales	(280,000)
	<hr/>
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	\$300,000
	<hr/>
Commissions Earned	\$ 20,000
Expenses, etc.	XXX

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

.02 Disposal of a Segment of a Business

Inquiry—A company in the construction business is disposing of a subsidiary which is in an unrelated field of business. Should this disposal be treated as a one line item as outlined in APB Opinion No. 30, paragraph 8?

Reply—Disposal of this subsidiary would constitute the disposal of a segment of a business as defined in APB Opinion No.

30, paragraph 13, and also as discussed in the examples of disposal of a segment in AICPA Interpretation No. 1 of APB Opinion No. 30. Therefore, the presentation in the income statement that is illustrated in APB Opinion No. 30, paragraph 8, would be appropriate.

.03 Discontinued Operations—Decision Reversed

Inquiry—Company A reversed, during the current year, its prior decision to discontinue the operations of a business segment. How should Company A report the current decision in its financial statements?

Reply—If the decision to discontinue the operations of a segment is later reversed, the income or loss from discontinued operations would be reclassified in the financial statements for the years in which the discontinued operations were reported separately. The later decision justifies reclassifying the components of net income. The changes in the components reported previously should be explained in the notes.

The reversal of a gain or loss on disposal of the segment that was recognized in a prior year would be included in net income for the year in which the decision was reversed because FASB Statement No. 16 restricts prior period adjustments to specified items. The reversal would be reported as a change in estimate in accordance with APB Opinion No. 20.

.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.”

➡➡➡ *The next page is 201.* ⬅⬅⬅

Section 1300

Statement of Changes in Financial Position

.01 Title of Funds Statement

Inquiry—In Accounting Principles Board Opinion No. 19, what used to be called the “Statement of Source and Application of Funds” is referred to as the “Statement of Changes in Financial Position.”

A client titles his balance sheet, “Statement of Financial Condition.” Would it be appropriate to title the corresponding funds statement, “Statement of Changes in Financial Condition”?

Reply—The term “Condition” would in most instances be just as acceptable as the word “Position,” and where the balance sheet is entitled “Statement of Financial Condition” use of the word “Condition” may be more appropriate.

.02 Title of Funds Statement When Fund is Cash

Inquiry—Several smaller clients prefer to have their statement of changes in financial position reflect the flow of cash rather than the flow of working capital. These statements are titled “Statement of Changes in Cash Position” and show “Cash provided by operations,” “Uses of cash,” and “Increase (or decrease) in Cash.” Is such a presentation at variance with Accounting Principles Board Opinion No. 19?

Reply—Paragraph 8 of APB Opinion No. 19 recommends that the statement be titled “Statement of Changes in Financial Position.”

The title of the statement should be the one recommended by the board even though the format shows the flow of cash. This approach is in effect saying that “the changes in financial position is being measured in terms of the flow of cash.”

Taking paragraphs 12a and 15 of APB Opinion No. 19 together, the term “cash provided by operations” could be used if the adjusted amount is adequately described as discussed in paragraph 15.

.03 Comparative Statements of Changes in Financial Position

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

Reply—Paragraph 7 of Accounting Principles Board Opinion No. 19 states in part, “When financial statements purporting to present both financial position . . . and results of operation . . . are issued, a statement summarizing changes in financial position should also be presented as a basic financial statement for each period for which an income statement is presented”.

Therefore, if a balance sheet is presented, a statement of changes in financial position should be presented for both current and prior period if income statements are presented for such periods.

.04 Elements of Working Capital

Inquiry—Paragraph 12 of Accounting Principles Board Opinion No. 19 provides that the changes in each element of working capital should be disclosed either in the statement of changes in financial position or a related tabulation. If comparative balance sheets and income statements are presented, is it necessary that the changes in elements of working capital also be shown in comparative form? Also, is it necessary to show the comparative balances of the elements of working capital, or is showing the increase or decrease in each item sufficient?

Reply—Although paragraph 12 of APB Opinion No. 19 states that “net changes in each element of working capital . . . should be appropriately disclosed for at least the current period”, usually the net changes in each element of working capital are presented in comparative form if comparative balance sheets are presented. The amounts of each element of working capital at the beginning and end of each year need not be shown in the statement of changes in financial position or a note. However, those amounts are presented in comparative balance sheets. [Amended]

.05 Statement of Changes in Financial Position for Annual Report with Balance Sheet Only

Inquiry—When only a statement of financial position is pre-

sented, is it necessary that the auditor's opinion be qualified relative to the omission of the statement of changes in financial position?

Reply—APB Opinion No. 19, paragraph 7, states:

When financial statements purporting to present both financial position and results of operations are issued, a statement summarizing changes in financial position should also be presented as a basic statement. . . .

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 changes in financial position, and no comment on the absence of such a statement is necessary.

.06 Format of Statement of Changes in Financial Position when Operations Result in an Application of Funds

Inquiry—The statement of changes in financial position usually has a format as follows:

Sources of Funds:

Funds provided by operations.....	xx	
Other sources of funds.....	xx	xx
	<hr/>	
Application of Funds:.....		(xx)
		<hr/>
Increase (Decrease) in Funds.....		xx

What is the proper format in the case when the company suffers a loss for the year and "Funds provided by operations" becomes an application rather than a source of funds?

Reply—APB Opinion No. 19, paragraph 10, states that the statement of changes in financial position "should begin with income or loss before extraordinary items." Therefore, where net losses result in a drain on working capital even after adding back expenses not requiring the outlay of working capital in the current period, the statement should still start with net income or loss before extraordinary items in accordance with APB Opinion No. 19. However, the major side captions may be changed to first show disposition of funds and then sources of funds.

.07 Statements of Changes in Financial Position for Nonprofit Organizations

Inquiry—APB Opinion No. 19, paragraph 7, specifies that the statement of changes in financial position should be presented

as a basic financial statement when a balance sheet and a statement of income and retained earnings are issued by a profit-oriented business entity. May this requirement be properly interpreted to mean that the statement of changes in financial position is not a requirement when reporting on financial position and operating results of a nonprofit organization?

Reply—The AICPA industry audit guides applicable to colleges and universities, voluntary health and welfare organizations, and funds (other than enterprise funds) of state and local governmental units state that those entities need not present a statement of changes in financial position because the essential information is presented in the other financial statements. The applicable AICPA industry audit guides and SOP No. 78-10 state that financial statements intending to present both the financial position and results of operations of hospitals, enterprise funds of local and state governmental units, and other nonprofit organizations should include a statement of changes in financial position. [Amended]

.08 Effect of Change in Depreciation Method on Statement of Changes in Financial Position

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. Should this change be shown on the statement of changes in financial position?

Reply—APB Opinion No. 19, paragraph 10, states in reference to the statement of changes in financial position, "The statement for the period should begin with income or loss before extraordinary items, if any, and add back (or deduct) items recognized in determining that income or loss which did not use (or provide) working capital or cash during the period." As indicated in APB Opinion No. 20, paragraph 20, "... the cumulative effect (of a change in accounting principle) should be shown in the income statement between the captions 'extraordinary items' and 'net income'."

The cumulative effect should be included in the statement of changes in financial position but in a way which clearly shows that it does not affect working capital.

A possible presentation for the cumulative effect of the change might be:

Sources of Working Capital

Income before cumulative effect of change in accounting principle	\$200,000
Add expenses not affecting working capital:	
Depreciation	500,000
	<hr/>
Working capital provided by operations.....	700,000
Cumulative effect of change in depreciation method:	
Increase in retained earnings.....	\$100,000
Less: increase in equipment.....	100,000
	<hr/>
Total funds provided during	
year	<hr/> <hr/> \$700,000

The effect of the change might also be shown in a separate section of the statement with a title such as, "Changes in financial position not affecting working capital."

.09 Presentation of Property Sold in Statement of Changes in Financial Position

Inquiry—There are two frequently used methods of presenting property sold in a statement of changes in financial position. One method is to show the book value of property sold as a source of funds. The second method is to reduce income or loss from operations by the gain or loss on the sale and to show the full proceeds as a source of funds not from operations. What is the correct method of presenting property sold in a statement of changes in financial position?

Reply—Reporting the book value of property sold as a source of funds continues to be used in practice. But, adjusting income or loss from operations by the gain or loss on the sale of the property and reporting the entire proceeds as a source of non-operating funds specifically conforms to the requirements stated in APB Opinion No. 19, *Reporting Changes in Financial Position*, paragraph 14. It states, in part:

In addition to working capital or cash provided from operations . . . and changes in elements of working capital . . . the Statement should clearly disclose: . . . Proceeds from sale

(or working capital or cash provided by sale) of long-term assets (identifying separately such items as investments, property, and intangibles) not in the normal course of business, less related expenses involving the current use of working capital or cash.

.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, is a statement of changes in financial position required?

Reply—APB Opinion No. 19, *Reporting Changes in Financial Position*, paragraph 7, states, in part:

When financial statements purporting to present both financial position (balance sheet) and results of operations (statement of income and retained earnings) are issued, a statement summarizing changes in financial position should also be presented as a basic financial statement for each period for which an income statement is presented.

SAS No. 14, *Special Reports*, paragraph 7, states, in part:

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

Accordingly, an entity presenting financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles is not required to include a statement of changes in financial position, since these statements do not purport to present both financial position and results of operations.

.11 The Effect of a Prior Period Adjustment on the Statement of Changes in Financial Position When Single Period Statements Are Presented

Inquiry—How would a prior period adjustment be presented in the statement of changes in financial position if single period statements are presented?

Reply—FASB Statement No. 16, *Prior Period Adjustments*, paragraph 16a, states that “prior period adjustments shall, in

single period statements, be reflected as adjustments of the opening balance of retained earnings." A corresponding prior period adjustment will normally result in a change in the beginning balance of an asset or liability account. APB Opinion No. 19, *Reporting Changes in Financial Position*, provides general guidance on that subject matter. In actual practice, the statement of changes in financial position is normally prepared by analyzing differences of all accounts presented in the beginning and ending balance sheets. 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, must be reflected in the statement of changes in financial position as either funds provided or applied, whichever is applicable, or as an adjustment to an account in the changes in components of working capital, when the working capital format is presented.

➡ The next page is 261. ←

Section 1400

Consolidated Financial Statements

.01 Operations of Subsidiaries and Parent Closely Related

Inquiry—Separate financial statements have been prepared for a parent company and for each of its two wholly owned subsidiaries which sell their entire production to the parent. The parent company accounts for its investments in the subsidiaries by the equity method. Should consolidated financial statements be prepared rather than separate financial statements?

Reply—The statements in paragraph 1 of ARB No. 51 that consolidated financial statements are presumed to be more meaningful and are usually necessary for a fair presentation were repeated in paragraph 4 of APB Opinion No. 18. If the conditions described in paragraph 2 of ARB No. 51 justify not consolidating a majority owned domestic subsidiary, or the conditions described in paragraph 8 of Chapter 12 of ARB No. 43 justify not consolidating a majority owned foreign subsidiary, the unconsolidated subsidiary should be accounted for by the equity method. The Accounting Principles Board stated in paragraph 14 of Opinion No. 18 that “the equity method is not, however, a valid substitute for consolidation and should not be used to justify exclusion of a subsidiary when consolidation is otherwise appropriate.” [Amended]

.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 proprietor. 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 net worth, 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.

**.05 Accounting for Investments on Unconsolidated Statements
Issued as Supplements to Consolidated Statements**

Inquiry—Parent company A owns 100% of DISC A and 60% of Parent B. Parent B owns 100% of DISC B.

Consolidated financial statements, with the unconsolidated statements as supplemental information, will be prepared. In the preparation of unconsolidated financial statements, how should the investments in the common stock of subsidiaries be shown?

Reply—Paragraph 14 of Accounting Principles Board No. 18, *Equity Method for Investments in Common Stock*, states in part, "The Board also concludes that parent companies should account for investments in the common stock of subsidiaries by the equity method in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity."

If consolidated and unconsolidated financial statements are presented, the cost method could be used for the unconsolidated financial statements because they would not be the financial statements of the primary reporting entity issued to the stockholders. But, the equity method would also be acceptable.

.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. Consolidated financial statements will be prepared, but is it also necessary to provide figures for the individual companies?

Reply—Paragraph 22 of Accounting Research Bulletin No. 51 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 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.

.08 Intercompany Profits in Inventories

Inquiry—One of the two divisions of a firm, in a group of brother-sister corporations, derives over 95% of its income from production of materials for a related company. All expenses are allocated to the divisions in a reasonable manner. It is therefore possible to determine the net profit remaining to the division.

How should the inventories be shown on the consolidated statements, and should intercompany profits be eliminated?

Reply—Generally, the inventories to be shown in consolidated statements should be valued on the same basis as they would have been had the enterprise been organized as one corporation, rather than as more than one.

ARB No. 51, *Consolidated Financial Statements*, paragraph 6, includes the following statement:

Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated; the concept usually applied for this purpose is gross profit or loss.

ARB No. 51, paragraph 17, points out:

If income taxes have been paid on intercompany profits on assets remaining within the group, such taxes should be deferred or the intercompany profits to be eliminated in consolidation should be appropriately reduced.

.09 Intercompany Profit on Sale of Receivables

Inquiry—A controlled brother and sister corporation in liquidation sold its receivables at a premium to another corporation controlled by the same brother and sister. The seller reported the premium as income in the current year of sales and the buyer corporation set up the premium as a deferred charge to be amortized over a five-year period on a monthly basis, commencing with the current year.

Must this transaction be eliminated when combined statements are prepared?

Reply—ARB No. 51, *Consolidated Financial Statements*, paragraph 6, requires elimination of intercompany profits in the preparation of consolidated and/or combined statements. Profits on sales of receivables should not be exempted from these requirements. [Amended]

.13 Presentation of Investment in Partnership

Inquiry—A company has an investment in a limited partnership engaged in the construction of an office building. In order to obtain outside investors for the office building partnership, the company has agreed that profits or losses for the first nine years of operation shall be allocated 70% to the outside investors and 30% to the company. At the expiration of the

nine years, the distribution of earnings or losses shall revert to 70% to the company and 30% to the outside investors. However, since the company is contributing 70% of the value to the office building partnership, it was agreed that upon sale of the office building, at any time, the company will receive 70% of the profit and the outside investors 30%.

Should the financial statements of the limited partnership be combined with those of the company or would the equity method of accounting have to be used?

Reply—Since the company “owns” 70% of the limited partnership, the financial statements of the limited partnership would be combined with those of the company on a line by line basis even though during the first nine years there would be a minority interest in earnings of 70%. If the company decides to issue only its own financial statements to the stockholders as “the financial statements of the primary reporting entity,” then the equity method described in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, would be appropriate. Refer also to the AICPA Interpretation No. 2 of APB Opinion No. 18, “Investments in Partnerships and Ventures.”

.14 Consolidation of Indirect Subsidiaries

Inquiry—Corporation A owns one hundred percent of the stock of corporation B. B owns ninety percent of Company C and one hundred percent of Company D.

Would companies C and D be considered subsidiaries of A or B? Should B show the investments in C and D according to the equity method when filing financial statements?

Reply—Companies C and D would be considered indirect subsidiaries of A, and direct subsidiaries of B. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, paragraph 14, states in part, “The equity method is not, however, a valid substitute for consolidation and should not be used to justify exclusion of a subsidiary where the consolidation is otherwise appropriate.”

Unless the financial statements of corporation B are being prepared for a special purpose for which recognition of equity in its subsidiaries is not appropriate, any failure to consolidate or

carry at equity basis its interests in corporations C and D should be considered a departure from generally accepted accounting principles.

.15 Temporary Loss of Control of Subsidiary

Inquiry—A company owns 55% of the voting stock of a subsidiary. However 10% of the stock has been assigned to a voting trust for a period of two years. The trustee of the voting trust is a representative of the minority interest, giving the minority interest voting control for a period of two years.

Should this subsidiary be consolidated or should it be accounted for by the equity method?

Reply—ARB No. 51, paragraph 2, in a discussion of consolidation policy states:

The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over 50% of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy). There may also be situations where the minority interest in the subsidiary is so large, in relation to the equity of the shareholders of the parent in the consolidated net assets, that the presentation of separate financial statements for the two companies would be more meaningful and useful.

Assigning 10% of the shares to the voting trust resulted in a temporary loss of control, a situation the opposite of “control is likely to be temporary.” Therefore, because the loss of voting control is only temporary, these subsidiaries should be consolidated in the parent company’s financial statements.

.17 Caption of Notes to Financial Statements

Inquiry—Should notes to financial statements be captioned as of the balance sheet date or for the period ended?

Reply—The caption is usually “Notes to Financial Statements” without date. Notes relate to the accompanying statements of income, statements of financial position, and statements of changes in financial position, each of which is dated. [Amended]

.18 Combined Statements for Corporation and Partnership Commonly Owned

Inquiry—A privately owned corporation leases property from a partnership whose sole business activity is leasing property to the corporation. The corporation and partnership are commonly owned. Are combined financial statements appropriate?

Reply—Combined financial statements for the corporation and partnership are appropriate. FASB Statement No. 13, paragraph 31, states:

The accounts of subsidiaries (regardless of when organized or acquired) whose principal business activity is leasing property or facilities to the parent or other affiliated companies shall be consolidated. The equity method is not adequate for fair presentation of those subsidiaries because their assets and liabilities are significant to the consolidated financial position of the enterprise.

Although the above refers to subsidiaries and consolidations, a section of ARB No. 51, paragraph 22, pertaining to combined statements, states the following:

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. 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 statements would also be used to present the financial position and the results of operations of a group of unconsolidated subsidiaries. They might also be used to combine the financial statements of companies under common management.

.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% 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, 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.

.20 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.

.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.)

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, 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.

»»→ *The next page is 301.* ←««

Section 1500

Cash Basis Statements or Modifications Having Substantial Support

.03 Presentation of Income Tax Expense in Cash Basis Financial Statements

Inquiry—Should the amount of income taxes paid during the year or the amount of income taxes accrued on current year's income be included in cash basis financial statements?

Reply—Paragraph 4 of Statement on Auditing Standards No. 14, in describing various comprehensive bases of accounting other than generally accepted accounting principles, states that recording depreciation or accruing income taxes in modified cash basis financial statements has substantial support. Cash basis financial statements should present the amount of taxes paid. If accrued taxes are presented, the financial statements would be on a modified cash basis.

.04 Terminology for Cash Basis Financial Statements

Inquiry—If a corporation presents cash basis financial statements, what should be the title of the “balance sheet”; what should be the caption for “net income” or “net loss”; and may the corporation use “retained earnings?”

Reply—SAS No. 14, paragraphs 7 and 8, indicate terminology which is appropriate for cash basis financial statements—for instance, “statement of assets and liabilities arising from cash transactions” would be used as a “balance sheet” title. The terms “net income”, “net loss”, and “retained earnings” are not mentioned specifically. The inference is that the caption should be “excess of revenue collected over expenses paid”, “excess of expenses paid over revenue collected”, and “accumulated excess of revenue collected over expenses paid.”

.05 Substantial Support for Modifications in Cash Basis

Inquiry—Many nonprofit organizations, partnerships, and small businesses prepare their financial statements in conformity with a modified cash basis of accounting, which may include departures from the cash basis of accounting. For example, the accrual basis of accounting (that is, generally accepted

accounting principles) may be applied to some items. Which modifications of the cash basis of accounting have “substantial support” under SAS No. 14, *Special Reports*, paragraph 4c?

Reply—The cash basis of accounting and modifications of the cash basis are not formalized in accounting literature as is the accrual basis of accounting. 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. 14. 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 (such as, 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 in his report an explanatory paragraph and modify the recommended language.

If the modifications are so extensive that the modified “cash-basis” statements are, in the auditor’s judgment, tantamount to financial statements on the accrual basis, the statements should be considered accrual basis. The auditor should use the standard form of report (SAS No. 2, paragraph 7), modified as appropriate because of departures from generally accepted accounting principles (SAS No. 2, paragraphs 15 through 17). 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), are not considered “modified cash-basis” financial statements.

»»→ *The next page is 451.* ←««

Section 1600

Personal Financial Statements

.01 Applicability of FASB Statement No. 12 to Personal Holding Companies

Inquiry—Does FASB Statement No. 12, *Accounting for Certain Marketable Securities*, apply to personal holding companies?

Reply—Yes. Statement No. 12, paragraph 5, lists the entities to which the Statement does not apply.

.02 Income Tax Provision Related to Estimated Current Value of Personal Residence Disclosed in Personal Financial Statements

Inquiry—SOP No. 82-1, *Accounting and Financial Reporting for Personal Financial Statements*, paragraph 30, states, in part:

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 . . . 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 date, using applicable income tax laws and regulations, considering recapture provisions and available carryovers . . . The methods and assumptions used to compute the estimated income taxes should be fully disclosed.

The present federal income tax laws provide two special tax benefits regarding the gain on the sale of a principal personal residence.

In estimating the income taxes related to the unrealized appreciation of the client's principal residence in his personal financial statements, can the client assume:

- 1) another home would be purchased within 24 months of the date on which the existing home was sold?
- 2) the principal residence will not be sold until after the client attains age 55?

Reply—The client's computations should not assume the purchase of another home within 24 months after the date on which

the existing home was sold. SOP No. 82-1, paragraph 30, basically provides for three assumptions as of the statement date: a) all assets had been realized at their estimated current values; b) all liabilities had been liquidated at their estimated current amounts; and c) a provision for estimated income taxes should be based on applicable income tax laws and regulations. Thus, the method and assumptions used to compute the estimated income taxes in accordance with SOP No. 82-1 relate to rates to be used based on existing tax law, not on assumptions of future actions of the individual after the financial statement date. This is also emphasized by the "assumptions used column" in Appendix B of SOP No. 82-1. Appendix B is an illustrative worksheet for determining the amount of estimated income taxes.

Similarly, the client's computations should not assume that his principal residence will be sold until after the client attains age 55. However, if the client has already reached age 55 and met certain occupancy conditions, part of the gain could be excluded from income in calculating the tax for personal financial statement purposes.

➤➤➤→ *The next page is 501.* ←➤➤➤

Section 1700

Prospective Financial Statements

.01 Omission of a Minimum Guideline in a Prospective Financial Statement

Inquiry—Statement on Standards for Accountants' Services on Prospective Financial Information, *Financial Forecasts and Projections*, Appendix A, presents minimum guidelines which should be followed for the presentation of prospective financial information. Included in these guidelines are primary and fully diluted earnings per share information. Must a nonpublic entity, exempt under FASB Statement No. 21, *Suspension of the Reporting of Earnings Per Share and Segment Information by Nonpublic Enterprises*, present earnings per share information in order to meet the minimum presentation guidelines for prospective financial information?

Reply—No. *Financial Forecasts and Projections*, Appendix A, "Minimum Presentation Guidelines," paragraph 1, states: "Prospective financial statements may take the form of complete basic financial statements or may be limited to the following minimum items (where such items would be presented for historical financial statements for the period)." Therefore, if a nonpublic company does not have to disclose earnings per share information under FASB Statement No. 21, it need not include this information with its prospective financial statements. Appendix A, paragraph 2, states that a prospective financial statement presentation which omits one or more of the applicable minimum items is a partial presentation, which is not covered by the statement. In the case of a nonpublic company, primary and fully diluted earnings per share are not applicable items; therefore, it is not a partial presentation and is subject to the provisions of the statement for prospective financial information.

TIS Section 2000

ASSETS

TABLE OF CONTENTS**Section****2100 Current Assets****2110 Cash**

- .01 Depositing Cash Receipts
- .02 Checks Undelivered at Balance Sheet Date
- .03 Drafts Outstanding as Reductions of Cash Balance
- .04 Bank Account of Debtor Held by Creditor

2120 Temporary Investments

- .01 Use of Current Assets to Meet Commitments for Purchase of Fixed Assets
- .02 Leveling Gains and Losses of Pension Trust [Amended]
- .03 Presentation of Cash and Temporary Investments
- .04 Valuation of Mutual Fund Investments in Debt Securities

2130 Receivables

- .01 Accrued Interest Revenue on Doubtful Receivables
- .02 Installment Receivables and Related Deferred Taxes as Current Assets and Liabilities [Amended]
- .03 Recoverable Customs Duties
- .04 Disclosure of Receivables Transferred [Amended]
- .05 Out-of-Pocket Costs Incurred by a Law Firm
- .06 Imputed Interest on Notes Receivable

2140 Inventories

- .01 Warehousing Included in Cost of Inventory
- .02 Obsolete Items in Inventory—I
- .03 Obsolete Items in Inventory—II
- .04 Airplanes Chartered While Held for Sale
- .05 Valuation of Rebuilt Airplane Parts Inventory
- .06 Inventory of Meat Packer
- [.07] Reserved
- .08 Valuing Inventory of Gold
- .09 Standard Cost for Inventory Valuation
- [.10] Reserved
- .11 Average Cost Method for Subsidiary
- .12 Classification of Replacement Parts Under a Maintenance Agreement
- .13 Classification of Slow-Moving Inventory

Section

2200 Noncurrent Assets**2210 Fixed Assets**

- .01 Settlement of Mortgage Installment on Real Estate Between Buyer and Seller
- .02 Commission Received by Purchaser of Property
- .03 Costs of Razing Building on Property Currently Owned
- .04 Cost of Cancellation of Option Granted on Land and Buildings
- .05 Date to Record Acquisition of Real Property by Government Agency
- .06 Valuation of Cattle Herd
- .07 Costs of Ski Slopes and Lifts
- .08 Restaurant Dishes and Silverware
- .09 Appraisal Value for Mailing Lists
- [.10] Reserved
- .11 Assets Transferred to Homeowners Association
- .12 Classification of Real Estate Held in Anticipation of Sale and Leaseback Transaction
- .13 Effect of Future Transfer on Accounting for Land
- .14 Facility Constructed by a Municipality for Exclusive Use of a Company
- .15 Capitalization of Cost of Dredging Log Pond [Amended]
- .16 Funds for Replacement of Equipment
- [.17] Reserved
- .18 Revaluation of Assets
- .19 Accounting for the Reduction in Tax Basis of an Asset
- .20 Compounding Capitalized Interest
- .21 Common Stock Issued in Exchange for Real Estate
- .22 Fixed Asset Partially Acquired With Grant Funds
- .23 Use of Cost-Based Appraisal for Valuation of Fixed Assets
- .24 Recording an Asset Under a Capital Lease

2220 Long-Term Investments

- .01 Equity Method When Current Direct Ownership Less than Twenty Percent
- [.02] Reserved
- .03 Equity Method for Investee Following Completed Contract Method
- [.04] Reserved
- .05 Assuming Pro Rata Share of Venture's Revenues and Expenses [Amended]

Section

- 2220 Long-Term Investments—Continued**
- .06 Recognizing Unrealized Appreciation of Hedge Fund [Amended]
 - .07 Equity Method for Small Business Investment Companies [Amended]
 - .08 Acquisition of Subsidiaries by Exchange of Assets with No Book Value
 - .09 Market Value of Unregistered Stock
 - .10 Elimination of Intercompany Profits
 - .11 Equity Method for Investments in Limited Partnerships and Unincorporated Joint Ventures
 - .12 Investor's Share of Losses in Excess of Its Investment
 - .13 A Change in Circumstances Using the Equity Method of Accounting for an Investment
- 2230 Noncurrent Receivables**
- [.01] Reserved
 - .02 Balance Sheet Classification of Deposit on Equipment to Be Purchased
- 2240 Cash Surrender Value of Life Insurance**
- .01 Balance Sheet Classification of Life Insurance Policy Loan
 - .02 Disclosure of Life Insurance on Principal Stockholders
 - .03 Omission of Cash Surrender Value of Life Insurance from Assets
 - .04 Corporation's Policy on Life of Debtor Corporation's Officer
 - .05 Purchase of Key-Man Life Insurance Policy from the Insured
- 2250 Intangible Assets**
- [.01] Reserved
 - .02 Change in Amortization Period for Contingent Consideration Carried as Goodwill
 - [.03] Reserved
 - .04 Appraisal Value of Intangible Assets [Amended]
 - .05 Reporting Write-off of Unamortized Goodwill
- 2260 Other Assets**
- .01 Accounting for Treasury Stock as an Asset
-

 **The next page is 721.** 

Section 2110

Cash

.01 Depositing Cash Receipts

Inquiry—What is the meaning of the phrase, “Receipts should be deposited intact?” Must the individual items of remittance such as checks, money orders, and cash be deposited, or is it sufficient to deposit the exact total amount of the receipts for a particular day?

Reply—Deposits received in the mail should be deposited exactly as received, with each check item appearing on the deposit ticket, and the cash items generally appearing as one total. The depositor should retain a list of the details making up the cash item. Remittances received over the counter should generally be handled separately from mail remittances. A record should be retained for each item received, although the deposit ticket generally will list separately only checks received. Frequently, counter receipts will be greater than the items due the organization since change will be given back. It would be desirable for each check item to show the amount for which payment was received and the amount paid out in change.

.02 Checks Undelivered at Balance Sheet Date

Inquiry—It is the practice of a client to draw checks to all of its creditors at the end of each month, thus resulting in a condition of no trade accounts payable at the end of each month. At the same time, after deducting these disbursements from cash in bank, large overdrafts may result from this procedure. However, since the client does not wish to deliver the checks against insufficient funds, the checks are kept in the possession of the client and mailed only after there are sufficient funds to cover the checks mailed.

Is it proper, as the client requests, for the auditor to take these checks still on hand and journalize the total back into cash in bank and credit trade accounts payable for this amount (since the checks have not actually been disbursed and since this internal record keeping suits the convenience of the client)? Also, is it mandatory that these held checks be voided first and new checks with new dates be prepared before the auditors can journalize such an entry?

Reply—It is not only proper but necessary that any checks dated prior to the balance sheet date and not mailed or otherwise delivered, be restored to cash by journal entry. In some instances, it may be difficult to determine which checks have not been mailed, although generally the auditor should be suspicious of any blocks of checks that are not returned with the next subsequent bank statements, or that are returned but show their first bank stamps later than two or three business days after the balance sheet date.

.03 Drafts Outstanding as Reductions of Cash Balance

Inquiry—A client has men out in the field. These men draw drafts on the company bank account for purchases, expense items, and advances (loans). At the close of the year, there usually are a few of these drafts in transit, but they have not been accepted by the company and could be refused. In the normal situation, however, they are accepted by the company. These amounts have always been very small in the past, but there is the possibility, of course, that the amounts could become material. Should the bank account be reduced for any or all of these drafts and the various expenses, loans, etc. be charged?

Reply—The bank account should be credited in the amount of the drafts in transit, and the applicable cost or expense classifications involved charged in the accounting period when drafts are written. Although such drafts must be approved by the company before actually being honored, a refusal, apparently, is unusual. Viewing the situation from the standpoint of a “going concern,” it would appear that all the elements of “incurring” an expense, or making a purchase, or an advance, take place prior to the year end. In addition, to defer recognizing these entries until approval is given, especially in view of the lack of materiality of the items and the few times rejections have taken place, gives too much weight to the concept of rigid accounting periods and not enough to the proper “matching” of costs and revenues.

.04 Bank Account of Debtor Held by Creditor

Inquiry—A corporation loaned the sum of \$27,000 to an individual. The individual subsequently repaid the loan by delivering his personal check to the corporation. In order that the funds represented by the check could continue to earn interest and not lie dormant in a checking account, the individual delivered to the corporation his savings bank pass books sufficient to cover the face amount of the check and also delivered to the corpora-

tion executed withdrawal slips covering those bank books. The corporation retained the check, the bank books, and the executed withdrawal slips. The corporate officer, who usually made entries in the original books of account of the corporation, made an entry showing the funds, represented by the check, as having been deposited by the corporation.

The rationale of the officer making the entry was that this transaction represented cash on hand or cash in the bank. The corporation would at any time be able to withdraw sufficient money from the individual's checking account to cover the check.

Is it correct to treat this amount as cash on the corporation's books?

Reply—In the absence of an opinion from an attorney that the cash in the savings bank belongs to the corporation, rather than to the individual, it would not be appropriate to include the amount in cash.

However, if the amount involved were merely being held in the savings bank in the name of the individual until the next succeeding interest date in order to avoid surrender of accrued interest, and if the transfer to the corporation was in fact made at such interest date, it might be appropriate to include a separate caption for "Cash in Savings Bank." In such circumstances it would of course be necessary to disclose the fact that at the date of the balance sheet the funds were not in the corporation's name, the reason for the delay in transfer, and that the transfer had in fact been made prior to the date of the report.

➤→ *The next page is 761.* ←➤

Section 2120

Temporary Investments

.01 Use of Current Assets to Meet Commitments for Purchase of Fixed Assets

Inquiry—A corporate client maintains its books and files its federal income tax returns on a cash basis method of accounting. At the end of the year, the company expects to have committed itself for additions to plant and equipment for the amount of \$10 million payable over a period of about one and one-half years.

The client has investments in government bonds valued at \$15 million and classified as current assets. The company maintains a policy of investing surplus funds in these securities and none of them are specifically earmarked for payment of the commitments when they come due, although it is quite possible that maturing bonds may be used for this program. In any case, the client intends to pay for the new plant out of working capital.

One of the directors has suggested that in the year-end financial statements the aggregate commitments and anticipated expenditures of \$10 million be deleted from current assets and shown “below the line,” presumably as a separate item or included in “Other Assets.” He has stated that in his opinion this matter would not properly be handled by only a footnote or inclusion in the auditor’s report.

How should this commitment be presented in the financial statements?

Reply—Presenting the amount expected to be spent to meet the commitments as noncurrent is not required. In reaching this conclusion, consideration has been given to par. 6, chapter 3A of Accounting Research Bulletin No. 43. This reference is construed to mean that a general intention to pay debts arising from a construction program out of funds or liquid assets which are otherwise properly categorized as current does not change that current status. Even though it is likely that the investments will be used to pay the commitments, management’s current state of mind could change. In the absence of some act such as a resolution of the board formally earmarking or appropriating the securities for payment of construction obligations, the securities will remain current assets.

The nature and the amounts of the commitments should, of course, be disclosed. Such disclosure by footnote to the balance sheet would be sufficient.

.02 Leveling Gains and Losses of Pension Trust

Inquiry—A client, a pension trust serving municipalities, reports gains and losses as they occur upon sales of securities.

These gains and losses along with other investment earnings, interest and dividends, have been credited to the equity of the individual cities. These credits have been used to reduce (or increase as the case may be) future contributions to the trust by the individual cities.

Since these gains and losses fluctuate greatly, would it be acceptable for the client to somehow level the gains and losses charged to the contributors while still reporting gains and losses only upon sales?

Reply—Generally accepted accounting principles call for reporting gains and losses on the sale of securities as they occur. These gains and losses, along with other investment earnings such as interest and dividends, would be appropriately credited to the equity of the individual cities in this case.

Investments of pension funds should be presented in the financial statements at their fair value at the statement date.

The net increase or decrease during the year in unrealized appreciation or depreciation of investments or realized gains and losses would be reported as a separate caption in the statement of changes in net assets available for plan benefits.

Any change toward leveling these securities gains and losses would have to be evaluated on the basis of possible departure from generally accepted accounting principles. [Amended]

.03 Presentation of Cash and Temporary Investments

Inquiry—Cash and temporary investments (such as certificates of deposit and marketable securities) are sometimes presented as either one amount without disclosing the components (the carrying basis and the current market value of the investments) or as an item of “cash and cash equivalents” without disclosing the nature of cash equivalents. Are such presentations acceptable?

Reply—Neither of the described presentations is acceptable. FASB Statement No. 12, *Accounting for Certain Marketable Securities*, specifies in paragraph 12 the disclosures in financial statements or accompanying notes.

ARB No. 43, Chapter 3A, paragraphs 4 and 9, apply to the reporting of other temporary investments (commercial paper, certificates of deposit, and marketable securities not covered by FASB Statement No. 12). Paragraph 4 implies that major components of current assets should be separately reported or disclosed and paragraph 9 stipulates that the “. . . amounts at which current assets are stated be supplemented by information which reveals, for temporary investments, their market value at the balance sheet date. . . .” Accordingly, the amount and market value of other temporary investments should be disclosed in the financial statements or accompanying notes.

.04 Valuation of Mutual Fund Investments in Debt Securities

Inquiry—What is the appropriate accounting for mutual fund shares owned by a manufacturing company when the investment policy of the mutual fund is to invest exclusively in debt securities, such as corporate bonds and government securities?

Reply—Ownership of shares in a mutual fund is within the definition of an equity security in FASB Statement No. 12, *Accounting for Certain Marketable Securities*, paragraph 7.

A marketable equity security is an equity security for which sales or bid and ask prices are currently available on a national securities exchange. Mutual funds typically compute their daily net asset value per share based on market prices of the securities in the portfolio, which is also in substantive agreement with paragraph 7.

Therefore, regardless of the fund's investment policy, mutual fund shares owned in a portfolio are appropriately accounted for under FASB Statement No. 12, paragraph 8, which states, the carrying amount of a marketable equity securities portfolio shall be the lower of its aggregate cost or market value, determined at balance sheet date.

➡ *The next page is 811.* ←

Section 2130

Receivables

.01 Accrued Interest Revenue on Doubtful Receivables

Inquiry—When should a lender stop accruing interest revenue on doubtful receivables?

Reply—In practice, when loan payments stop, banks often stop accruing interest income. While there is no hard and fast rule, interest income accrued in the current year is usually reversed and interest related to prior years is charged to the reserve for loan losses.

The practice of not accruing interest on doubtful loans is also prevalent in the real estate industry.

It is a matter of judgment as to when a lender should stop accruing interest on a doubtful receivable. In any case, it is unrealistic to recognize income which probably will not be collected.

.02 Installment Receivables and Related Deferred Taxes as Current Assets and Liabilities

Inquiry—Is it an accepted accounting principle to classify long-term installment receivables and their related deferred income tax credit as current assets and liabilities?

Reply—ARB No. 43, Chapter 3, Section A, paragraph 4, indicates that the term “current assets” includes installment or deferred accounts and notes receivable if they conform generally to normal trade practices and terms within the business. APB Opinion No. 11, paragraph 57, as amended by FASB Statement No. 37, paragraph 4, states, “A deferred charge or credit that is related to an asset or liability shall be classified as current or noncurrent based on the classification of the related asset or liability.” Accordingly, if a corporation classifies its installment notes receivable as current on the theory that they conform generally to normal trade practices and terms within the business, the applicable deferred income tax liabilities should also be classified as current. [Amended]

.03 Recoverable Customs Duties

Inquiry—A client imports into the United States a product subject to duty. As a processor, he may file a claim for refund of

99% of the amount of duty paid upon submitting proof of a comparable shipment exported from the United States. There must be some change in this product, prior to shipment, such as canning or blending which changes the form of the original product imported. The client has been exporting sufficient goods so that the maximum duties have been recoverable in prior years.

What is the proper treatment for such recoverable duties?

Reply—It is appropriate to treat recoverable duties on exports made prior to the balance sheet date as an asset. Duties on goods in the ending inventory may be shown as an asset since this cost would be charged to the subsequent period, whether the goods are used domestically or exported.

.04 Disclosure of Receivables Transferred

Inquiry—On the last day of its fiscal year, Corporation A transferred its accounts receivable at 100% of face amount to a commercial bank which held back 10% of the face amount of receivables transferred. The transfer was without recourse except that the bank may charge the holdback account for delinquent accounts. However, the holdback account can never exceed 10% of the balance of the accounts due to the bank. In lieu of a discount at the time of the transfer, Corporation A will pay the bank $\frac{1}{2}$ of 1% over the prime rate on the amount of outstanding receivables. For tax purposes, Corporation A will adopt the installment basis. How should the transfer of receivables be presented and disclosed in the financial statements of Corporation A?

Reply—FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*, Appendix B, indicates that holdbacks are a common recourse provision. Accordingly, the receivables transferred by Corporation A should be treated as receivables transferred with recourse for purposes of financial reporting.

If the transfer meets the conditions stated in Statement No. 77, paragraph 5, the transfer is reported as a sale and gain or loss recognized at the time of transfer. Resulting timing differences would be reported in accordance with APB Opinion No. 11. If the transfer does not meet the conditions of paragraph 5, proceeds from the transfer are reported as a liability.

Although the accounts receivable were transferred on the last day of Corporation A's fiscal year, the tax effect is still the result of a transfer of receivables made in that fiscal year. Therefore, the election to use the installment basis of reporting for tax purposes should be mentioned in the financial statements for that year. [Amended]

.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 case is won, these costs are recovered from the client in addition to the legal fees. If the case is lost, the costs may not be recovered. How should these costs be treated by the law firm?

Reply—These out-of-pocket costs should be set up in a "client disbursements" account and the estimated recoverable amount should be shown as an asset in the financial statements of the law firm. If these out-of-pocket costs become uncollectible because a case is lost, they should be written off.

.06 Imputed Interest on Note Receivable

Inquiry—An account receivable arising from the normal course of business, maturing in less than one year, was converted to a note receivable, maturing after one year, with no stated interest. Should interest be imputed on the note receivable?

Reply—Yes. Receivables and payables arising in the normal course of business, which mature in less than one year, are exempted from interest imputation under APB Opinion No. 21, *Interest on Receivables and Payables*, paragraph 3(a). However, a note receivable which has a fixed maturity date after one year is subject to interest imputation as indicated in APB Opinion No. 21, paragraph 2.

➡ **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.

The discussion includes the following:

Selling expenses constitute no part of the inventory costs.

To the extent that warehousing is a necessary function of importing merchandise before it can be sold, certain elements of warehousing cost might be considered an appropriate cost of inventory in the warehouse. For example, if goods must be brought into the warehouse before they can be made ready for sale, the cost of bringing such goods into the warehouse would be considered a cost of inventory. Similarly, if goods must be handled in the warehouse for assembly or for removal of foreign packaging, etc., it would be appropriate to include such costs in inventory. However costs involved in storing the goods for any additional period would appear to be period costs. Costs of delivering the goods from the warehouse would appear to be cost of goods sold, and should not under any circumstances be allocated to 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 “non-useful” 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. Accounting Research Bulletin No. 43, Chapter 4, Inventory Pricing Statement No. 1, 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.”

.05 Valuation of Rebuilt Airplane Parts Inventory

Inquiry—A client operates as an aircraft repair shop certified by the Federal Aviation Administration. In addition to maintaining a stock of new parts, the client also salvages and rebuilds certain used parts. Once these rebuilt parts are approved by the FAA, they are as acceptable as new parts, and no differentiation between new and rebuilt parts is required in ordering, using, or pricing the parts.

For certain operating reasons, the client prefers to carry all parts at the factory list price for new parts. How should the necessary adjustments be made to reflect the actual cost of the used parts on the client’s financial statements?

Reply—One approach would be to advise the client to prepare a work order for each salvaged piece of equipment that is to be disassembled for parts. The work order would be used to accumu-

late (1) cost of the salvaged equipment, (2) direct labor incurred in disassembling, cleaning, and testing the salvaged parts, (3) cost of any outside work performed, and (4) an overhead allocation. At the completion of the disassembly and testing process, the air-worthy parts would be listed, valued at factory list price, and added to inventory at that value. The difference between the factory list prices and the actual cost as reflected by the work order would be entered (normally as a credit) in an inventory valuation account carried in the cost of sales section of the general ledger.

Assume that, at financial statement date, additions to parts inventory (new and used) for the given period amount to \$100,000; that the inventory valuation account reflects a credit balance of \$40,000 (40% of inventory additions); and that the inventory of parts, valued at factory list price, amounts to \$25,000. For statement purposes, parts inventory would be reduced by \$10,000 (40%) with a corresponding reduction in the inventory valuation account. The remaining \$30,000 in the inventory valuation account would be treated as a reduction to cost of parts sold. Assume further, that the parts inventory turns over every three months. The percentage of inventory reduction would be computed based on parts acquisition for the preceding three months only. Such a method of inventory valuation would be a sort of average cost method that would reasonably approximate actual cost on a first-in first-out basis.

.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 Statement 9 of Chapter 4, Accounting Research Bulletin No. 43. 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 Inventory of Gold

Inquiry—A client, a dental laboratory, has an inventory of gold which is held in a bank safety deposit box. The auditor intends to observe the physical inventory as well as have a sample of the gold tested for purity.

Should the gold be valued at cost or at the current market price?

Reply—Accounting Research Bulletin No. 43, Chapter 4, Statement 9 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.

The usual method of valuing an inventory of gold held for use in manufacturing is to value the gold at the lower of cost or market and disclose the excess of the market value over the carrying value.

.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.

»»»→ The next page is 867. ←«««

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.

➡ The next page is 1161. ⬅

Section 2210

Fixed Assets

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

Inquiry—A client recently acquired an office building. At the closing of the purchase, the seller turned over to the buyer the accrued interest on the mortgages as well as the pro rata portion of principal payments on the mortgages to the date of settlement.

Should the principal payments received be considered a reduction of the purchase price or income?

Reply—The accrued interest and principal payments on the mortgage paid by the seller to the buyer are adjustments of the cost of the property to the buyer and in no way constitute income.

For example, assume the following facts: Buyer acquires real property for \$100,000, representing the sum of \$10,000 cash and the assumption of a \$90,000 mortgage. At the same time, seller pays buyer \$2,500—\$2,000 on the mortgage principal and \$500 interest due at the time. (Rather than buyer giving seller \$10,000 and seller repaying buyer \$2,500, a net \$7,500 cash would probably change hands, but the two have not been “netted” out so that the hypothetical case is easier to follow.) The following journal entries are suggested as being the proper accounting for the transactions:

<i>Dr.</i> Office Building	\$100,000	
<i>Cr.</i> Mortgage Payable		\$90,000
Cash		10,000
<i>Dr.</i> Cash	\$ 2,500	
<i>Cr.</i> Interest Expense		\$ 500
Office Building		2,000
(to record acquisition)		

When buyer pays mortgagee the \$2,500, then the following entry would be made.

<i>Dr.</i> Interest Expense	\$ 500	
Mortgage Payable	2,000	
<i>Cr.</i> Cash		\$ 2,500
(payment of installment on mortgage)		

After these three entries have been made, the property and mortgage payable accounts would be \$98,000 and \$88,000 respectively—representing the actual cost of the property to the buyer

as well as the actual amount of the mortgage that it assumed. Note that the interest expense account has a zero balance because it essentially was a “wash” account—as was the cash account regarding the \$2,500. Buyer has, in a sense, acted as trustee to pay over this \$2,500, inasmuch as it was merely a stakeholder as to the principal and interest due as of the date of purchase.

.02 Commission Received by Purchaser of Property

Inquiry—A corporation entered into a contract to purchase real property. As part of the transaction, the corporation received a commission from the real estate broker (who was paid by the seller).

Would this commission be considered as income to the corporation or as a reduction of the cost of the property acquired?

Would it make any difference in the answer to this question if a wholly owned subsidiary of the corporation which acquired the property were to receive this commission?

Reply—The “commission” received from the broker most certainly should be treated as a reduction of the cost of the realty rather than as income. To account for this payment otherwise would violate the generally accepted accounting principle that income should not be recognized on a purchase. The receipt of the commission was part of a single transaction, viz.: the acquisition of certain real property, and is really an adjustment of the cost of that property. Future years’ income statements will benefit through reduced depreciation charges taken on a lower cost than would have been reflected had income been recorded initially.

From the viewpoint of the consolidated entity, the result will be the same whether the property is purchased by the parent who also receives the commission or if the commission is paid to the subsidiary. The reason for this is that payment to the subsidiary will result in a donated capital account being credited (no credit to any income account should be made because the subsidiary has earned nothing through this shifting of accounts). The donated capital account will then be eliminated upon consolidation, against the realty account appearing on the parent’s books. One of the reasons that consolidated statements are presumed to give the fairest presentation is because of situations such as that being discussed here. This coupled with the fact that the subsidiary is 100% owned would require consolidated statements in this instance. If, for one reason or another, individual statements

of the parent or of the subsidiary are prepared, then full disclosure of the particulars of this transaction is mandatory and should be made on the financial statements of each company.

.03 Costs of Razing Building on Property Currently Owned

Inquiry—A corporation acquired a site for the construction of a building ten years ago. The expected life of this building was estimated to be forty years at that time. Currently the building is being demolished because of obsolescence, and a completely new structure is being built. Should the undepreciated cost of the old building be carried forward as part of the cost of the new building, or should it be charged off to income?

Reply—It is a generally accepted accounting principle that useful costs be carried forward to be matched against future revenues because such costs are expected to contribute to the profit-making efforts of the company. When costs cannot reasonably be expected to help generate future revenues, they should be charged off as having expired, or as having been lost. The undepreciated cost of the old building in this situation is quite clearly lost because it cannot possibly generate subsequent earnings. If any part of the old structure is maintained, then an allocation of the undepreciated cost should be made and part of that cost should be assigned to this segment, because this section will be useful to the company in the future.

Had the corporation purchased land with the building with the intent of razing that building when the acquisition was made, then the costs of demolition would properly be reflected as part of the cost of the land, because the land was really the consideration bargained for, and its cost was, substantively, the purchase price plus the cost of razing the unwanted structure. Such is not the case here, however, and the undepreciated cost of the old building (assuming total destruction) should be charged to current income.

.04 Cost of Cancellation of Option Granted on Land and Buildings

Inquiry—Several years ago, a company entered an agreement with a customer whereby the customer would take the entire output of one of the company's plants. As part of the consideration, the company gave the customer an option to purchase the plant at a future date at a price which is adjusted annually for capital additions and depreciation.

As the option date approaches, the company would now like to negotiate with the customer for the cancellation of the option. This would undoubtedly call for the company to make some payment to the customer.

If this transaction occurs, how should the matter be shown in the financial statements? Should the cancellation cost be divided between the land and the plant?

Reply—It would be proper to allocate the cost of the option between land and building and equipment with the latter portion amortized over the remaining useful lives of the assets. Both of these might be included in the balance sheet as “Other Assets” or directly in “Land” or “Buildings” if proper disclosure is made either in the captions or in a note to the financial statements that the cost includes amounts paid for the cancellation of the option. It would not be proper to include in the land account the applicable portion without such disclosure.

.05 Date to Record Acquisition of Real Property by Government Agency

Inquiry—A state government deposits funds in escrow for the acquisition of real property. When should the value of the real property be recorded?

Reply—The transaction in question may involve various practical situations that require one accounting treatment rather than another. For example, the purchaser may make full deposit in escrow, and the contract is wholly executed on the purchaser’s side and partially or wholly executory on the vendor’s side. Or a portion of the purchase price may be deposited in escrow with further deposits in escrow to be made; the contract, therefore, being only partially executed on purchaser’s side and wholly or partially executory on vendor’s side. Or, a combination of the foregoing situations may exist. The purchaser may also gain possession and use of the property prior to final clearance by the escrow agent or the vendor may retain possession and use prior to final clearance.

There are two basic alternatives for handling the transactions in question.

1. Account for and reflect in the financial statements only the deposits in escrow actually made in connection with the acquisition of real property. Footnote pertinent details of the accounting entity’s contractual commitment respecting the real property.

Set up the cost of the property only when the deed is passed upon release from escrow.

2. Set up the full cost of property at inception of contract together with a liability for any remaining balance of the purchase price beyond the initial deposit. For financial presentation purposes, the liability may be shown on the liability side or as an offset deducted from the asset, thereby indicating the equity of the accounting entity in the property. As a matter of policy to be consistently applied, the accounting entity may decide to set up the cost of the property not at the time of entering into a binding contract of purchase, but only upon obtaining possession and use of the property, or upon depositing the full consideration for the property in escrow, or only upon the concurrence or occurrence of both these events.

The treatment described under "1" seems preferable on the ground that passage of title is the primary and conclusive operative fact attesting that all conditions precedent set forth in the escrow agreement have been satisfied and that the purchaser has untrammelled rights to the property.

.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, with rare exception, 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, of course, be properly treated as a period cost.

.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

Inquiry—A client distributes various advertising materials by mail, and has developed mailing lists over a number of years. The costs of preparing and maintaining the lists have been expensed through last year. Although the company will continue to expense the costs of maintaining and updating such lists, it has capitalized an amount equal to what it considers a current

estimated replacement cost of the mailing lists and credited "Appraisal Surplus." There is no way of reconstructing the actual costs incurred in prior years to prepare the mailing list.

The amount capitalized represents 25% of the client's total assets, and the client does not intend to amortize the capitalized amount because in its opinion, these lists have an unlimited useful life.

Is this the proper accounting treatment for these mailing lists?

Reply—The recording of the mailing lists at their estimated replacement cost would not be in accordance with generally accepted accounting principles. If the client is adamant about recording the mailing list as described, "Appraisal Surplus" would be the appropriate account to credit under the circumstances, but the auditor should issue a qualified or adverse opinion in accordance with Statement on Auditing Standards No. 2.

.11 Assets Transferred to Homeowners Association

Inquiry—What is the proper financial statement presentation and valuation of common area properties turned over to a homeowners association by a real estate developer?

Reply—These assets should be recorded as fixed assets at their fair market value at the date of transfer to the homeowners association in accordance with Accounting Principles Board Opinion No. 29, paragraph 18, which indicates that a non-monetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received.

.12 Classification of Real Estate Held in Anticipation of Sale and Leaseback Transaction

Inquiry—A company conducts a retail business at several locations. When a suitable store is found, the company will purchase the building and within a few months will arrange a sale and leaseback agreement for the property.

During the period between the date of the purchase of a store and the date of the sale and leaseback transaction, the company would record the investment in the store as a current asset. Recently the company made such a temporary investment but has been unable to negotiate a suitable sale and leaseback agreement. The investment was carried as a current asset in last year's financial statements. Should the store be reported as a

noncurrent asset in the current financial statements since at this time there is no way of determining when a prospective sale and leaseback arrangement will be consummated?

Reply—The reclassification of the investment in real estate to a noncurrent asset is appropriate under the circumstances. There should be adequate footnote disclosure of the circumstances which led to the reclassification. In connection with reporting this item in the statement of changes in financial position, the “funds applied” part of the statement should reflect the reclassification of the real estate.

Since the reclassification results from changed circumstances, and, assuming adequate disclosure, no reference to it is required in the auditor’s report.

.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, 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.

.14 Facility Constructed by a Municipality for Exclusive Use of a Company

Inquiry—A municipality levied a special tax assessment against the real estate of Corporation A equal to the estimated construction cost of a pollution control facility that the municipality agreed to construct for the exclusive use of Corporation A. Corporation A will pay the special assessment in equal annual installments plus interest over a fifteen year period. The municipality sold Special Assessment Bonds to finance construction of the facility and will pay principal and interest from the special assessment levied against the real estate of Corporation A. Corporation A will pay the cost of operating and main-

taining the facility. How should the corporation report the transaction?

Reply—Using Special Assessment Bonds to finance the construction of a pollution control facility is similar to using Industrial Revenue Bonds. The terms of the agreement to construct the facility indicate that the corporation should capitalize the cost of the facility in its financial statements at the present value of the series of payments required by the special assessment.

.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]

.16 Funds for Replacement of Equipment

Inquiry—A nonprofit hospital estimates that it will require \$x to replace existing equipment within the next five years. May additions to a fund for equipment replacement be charged to income annually?

Reply—No. AICPA Industry Audit Guide, *Hospital Audit Guide*, page 5, states:

Accumulation of funds for replacement or expansion of hospital facilities may result from a decision of the governing board to set aside resources for such purposes. When this is the case, these accumulations are considered to be designations of unrestricted fund balance and should be accounted for as appropriations of that balance. Provision for such designations of unrestricted fund balance should not be reflected as an expense in the statement of revenues and expenses.

The hospital may disclose in notes to the financial statements that \$x will be required for future replacement of equipment.

.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 incorporated) 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, 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.

.19 Accounting for the Reduction in Tax Basis of an Asset

Inquiry—Effective for eligible assets acquired in 1983, entities are required to reduce the tax basis of certain fixed assets by 50% of the amount of the related investment tax credit if the full credit is taken. FASB Technical Bulletin 83-1, *Accounting for the Reduction in the Tax Basis of an Asset Caused by the Investment Tax Credit*, paragraph 6, indicates that there may be two effects on deferred taxes when this happens: a) differences resulting from the reduction in the tax basis of an asset caused by the investment tax credit; b) differences between financial reporting depreciation and accelerated cost recovery system (ACRS) deductions. Therefore, why does the illustration

in Appendix A of Technical Bulletin 83-1 show a deferred tax of \$23,000 as “the effect of full investment tax credit flow-through”?

Reply—The difference between depreciation for financial reporting and ACRS deductions is a timing difference covered by APB Opinion No. 11, *Accounting for Income Taxes*, in which the income tax provision is based on pre-tax accounting income and the effect of the timing difference on the deferred tax liability is based on the difference between financial reporting income and taxable income (the “with and without method”).

The illustration assumes the full investment tax credit (\$100,000) was recognized as a credit to income tax expense for financial reporting purposes, which is in accordance with APB Opinion No. 11, just as the full investment tax credit was realized for income tax purposes. Accordingly, there is no timing difference related to the investment tax credit, in and of itself. However, the income tax law requires that the tax basis of the asset be reduced by 50% of the investment tax credit used, and generally accepted accounting principles do not require a similar reduction; that difference between the basis of the asset for income tax purposes (\$950,000) and for financial reporting purposes (\$1,000,000) necessitates a deferred tax charge of \$23,000 ($\$50,000 \times 46\%$) to recognize the timing difference inherent in the difference in basis. This timing difference will “turn around” in future periods because future ACRS deductions will not be as large, in the aggregate, as depreciation for financial reporting purposes. The resultant deferred taxes of \$23,000 are amortized as a credit to income tax expense when taxable income exceeds financial reporting income as a result of both the basis reduction and the difference between the lives used for ACRS deductions and for financial reporting depreciation.

.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, 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.

.21 Common Stock Issued in Exchange for Real Estate

Inquiry—A corporation issued additional shares of its common stock to an existing 10% shareholder in exchange for real estate. This transaction increased the stockholder’s interest to 45%. How should the shares of stock and real estate of this nonmonetary transaction be valued in the corporation’s financial statements?

Reply—In practice, nonmonetary assets acquired by issuing stock in a nonreciprocal transaction are stated at cost measured by the fair values evident in the transaction. APB Opinion No. 16, *Business Combinations*, paragraph 67, states, “Restrictions on measurement have led to the practical rule that assets acquired for other than cash, including shares of stock issued, should be stated at ‘cost’ when they are acquired and ‘cost’ may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is more clearly evident.”

This is also the basic principle underlying APB Opinion No. 29, *Accounting for Nonmonetary Assets*, although the acquisition of nonmonetary assets or services on issuance of capital stock of an enterprise is explicitly excluded from the scope of that opinion.

.22 Fixed Asset Partially Acquired With Grant Funds

Inquiry—A company is building an energy improvement asset for use in its manufacturing process. The local public utility has agreed to reimburse the company 80% of the asset’s cost once construction is complete. Should the amount received

from the public utility be used to reduce the asset cost or reported as revenue when construction is complete?

Reply—Authoritative accounting pronouncements do not provide specific guidance on accounting for benefits received from public utilities. However, it would seem appropriate to follow the guidance in an Accounting Standards Division Issues Paper, *Accounting for Grants Received From Governments*, paragraph 40, which states that grants related to depreciable fixed assets should be reported as income over the useful lives of the assets, and grants related to land should be amortized over the life of the depreciable fixed assets built on the land.

.23 Use of Cost-Based Appraisal for Valuation of Fixed Assets

Inquiry—An individual is contributing various fixed assets and cash to a corporation which he is forming. The individual will own 100% of the corporation. It would be preferable to record these assets at historical cost. The individual has no records concerning the historical costs of these assets. Is there a method that can be used to approximate the historical cost of the assets?

Reply—This situation is similar to a situation in which a nonprofit organization is required to record fixed assets already in use when historical costs are unavailable. SOP No. 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, paragraph 105, requires such organizations that have not previously capitalized fixed assets to capitalize retroactively assets already in use at their historical cost. However, SOP No. 78-10 states that another reasonable basis may be used if historical cost is unavailable and mentions “cost-based appraisals” as among the acceptable alternatives.

Under the cost-based appraisal method, the current appraised value of an asset is determined and the amount so determined is restated in terms of the price level prevailing at the asset's acquisition date using an appropriate price index, such as Consumer Price Index. The basis of recording the asset should be disclosed in the notes to the financial statements.

.24 Recording an Asset Under a Capital Lease

Inquiry—A Corporation acquires a fixed asset under a 5 year capital lease to which the following applies:

- a. The fair value is \$45,000.
- b. A bargain purchase option of \$10,000, available at the termination of the lease, has a present value of \$7,100 using the company's incremental borrowing rate of 7%.
- c. The present value of the minimum rental payments, using the company's incremental borrowing rate of 7%, after deducting executory costs, is \$39,000.

At what amount should the asset be recorded? How should the payment of \$10,000 required under the bargain purchase option be recorded?

Reply—FASB Statement No. 13, *Accounting for Leases*, paragraph 5(j), indicates that the payment called for by the bargain purchase option, and the minimum rental payments, shall be included in the minimum lease payments. FASB Statement No. 13, paragraph 10, states that if the present values of the minimum lease payments exceed the fair value of the leased property, then the amount recorded as an asset and liability shall be the fair value.

Accordingly, the asset and liability should be recorded at the fair value of \$45,000 since it is less than the present value (\$46,100) of the minimum lease payments. This would require an adjustment to the interest rate from the company's incremental borrowing rate to the interest rate implicit in the lease. As each rental payment is made, it should be allocated to principal and interest. The final payment of \$10,000 (the price of the bargain purchase option) should fully liquidate the balance of the liability.

➡ *The next page is 1261.* ←

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—Paragraph 17 of Accounting Principles Board Opinion No. 18 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—Paragraph 3(f) of Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, 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.

.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—Paragraph 19-c of APB Opinion No. 18 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, Interpretation No. 2 of APB Opinion No. 18, 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 78-9, *Account-*

ing for Investments in Real Estate Ventures, paragraph 11.
[Amended]

.06 Recognizing Unrealized Appreciation of Hedge Fund

Inquiry—A client owns a 40% interest in a partnership commonly known as a “hedge fund.” The client accounts for the investment by the equity method. The hedge fund records the unrealized appreciation of its investments according to generally accepted accounting principles. Should the client include in its income its pro rata share of the hedge fund’s unrealized appreciation?

Reply—Yes. Accounting Interpretation No. 2 of APB Opinion No. 18, entitled *Investments in Partnerships and Ventures*, states that many of the provisions of APB Opinion No. 18 would be appropriate in accounting for investments in unincorporated entities. APB Opinion No. 18, paragraph 3f, defines earnings or losses of an investee as net income or net loss “determined in accordance with accounting principles generally accepted in the United States.” Accordingly, the investor’s 40% share of the hedge fund’s net income would include the unrealized appreciation. [Amended]

.07 Equity Method for Small Business Investment Companies

Inquiry—APB Opinion No. 18, concerning the equity method of accounting for investments, exempts Small Business Investment Companies from its provisions in certain circumstances. Does the exemption apply to Small Business Investment Companies that have sold their stock publicly?

Reply—The provisions of APB Opinion No. 18, paragraph 2, are intended to exclude all investment companies.

The AICPA Industry Audit Guide, *Audits of Investment Companies*, includes accounting principles and financial statements for investment companies. Valuation of securities is discussed on pages 15-17 of the Guide. Investment companies should, in general, report their security investments at value. Guidance is provided on determining value. [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—Accounting Principles Board Opinion No. 18, paragraph 19 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. . . .” Intercompany profit eliminations under the equity method is discussed in Interpretation No. 1 to Opinion 18 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 paragraph 19 of Opinion No. 18 and Interpretation No. 1 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 paragraph 19n of Opinion 18 and paragraph 88 of Opinion 16.)

.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 7½% 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.

.10 Elimination of Intercompany Profits

Inquiry—A parent company reflects its wholly owned subsidiaries on the equity basis in its financial statements. There are many intercompany transactions. Should just the unrealized profits or losses be eliminated from the financial statements or should the entire transaction, sales, cost of sales and related profits be eliminated?

Reply—Accounting Interpretation No. 1 of Accounting Principles Board Opinion No. 18, states in part:

Paragraph 19 of APB Opinion No. 18 normally requires an investor's net income and stockholder's equity to be the same from application of the equity method as would result from consolidation. Because the equity method is a "one-line" consolidation, however, the details reported in the investor's financial statements under the equity method will not be the same as would be reported in consolidated financial statements (see paragraph 19-c). 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.

Therefore, in transactions between a parent company and its wholly owned subsidiaries, only unrealized profits or losses should be eliminated when the investments are reported on the equity basis in parent company financial statements.

.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 Corporation 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 Accounting Interpretation No. 2, "Investments in Partnerships and Ventures," of APB Opinion No. 18 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 undi-

vided 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.

APB Interpretation No. 2 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 APB Interpretation No. 2, 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 .05, relates to investments accounted for by either the cost method or the equity method and states:

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 following forms:

a. Audited Financial Statements

Financial statements of the investee generally constitute sufficient evidential matter as to the equity in underlying

net assets and results of operations of the investee when such statements have been examined by the investor's auditor or by another independent auditor whose report is satisfactory, for this purpose, to the investor's auditor . . .

.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*, 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 19 i, 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

*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.]

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 19(i). 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, 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.

➤➤➤→ *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.

➡ *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 operat-

ing 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.

.05 Purchase of Key-Man Life Insurance Policy from the Insured

Inquiry—A corporate officer was the owner of and paid \$70,000 in premiums on a \$1,000,000 life insurance contract on his life with his wife as beneficiary. The corporation purchased the in-

surance contract for business purposes at a price of \$70,000 changing the ownership and beneficiary to the corporation.

The corporation carries the insurance contract as an investment, at cost, which exceeded the cash surrender value at date of purchase by \$40,000. The corporation amortized this \$40,000 amount over the 15 year actuarial life expectancy of the insured as an annual charge against earnings. Is this treatment in conformity with generally accepted accounting principles?

Reply—Accounting Research Bulletin No. 43, Chapter 3, Section A indicates that cash surrender value of life insurance policies should be presented as a noncurrent asset. Accounting Interpretation No. 1 to Accounting Principles Board Opinion No. 12 states that the generally accepted method of accounting for non-term insurance on the life of a corporate officer is to charge the increase in the cash surrender value of the policy to an asset account and to charge the remaining balance of the annual premium to expense. This treatment would apply to any current premiums the corporation pays on the policy. However, the amount paid to the officer in excess of the cash surrender value of the policy at the date of purchase should be amortized over the life expectancy of the officer.

➡➡ *The next page is 1451.* ⬅⬅

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.

➤➤➤→ *The next page is 1501.* ←➤➤➤

Section 2260

Other Assets

.01 Accounting for Treasury Stock as an Asset

Inquiry—ARB No. 43, Chapter 1A, *Prior Opinions*, paragraph 4, states “. . . it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed. . . .” Under what circumstances would this be appropriate? What would be the title of the asset in the balance sheet?

Reply—Treasury stock has been reported as an asset in the balance sheet when a corporation purchases its own stock as part of a systematic method of fulfilling its requirements to issue shares in connection with an employee stock option plan.

A title used for this presentation may be “Common Stocks Held for an Employee Incentive Program.” Some public companies reflect it between current and fixed assets.

TIS Section 3000

LIABILITIES AND DEFERRED CREDITS

TABLE OF CONTENTS

Section

3100 Current Liabilities

- .01 Estimated Liability for Unemployment Claims
- [.02] Reserved
- .03 Accounting for Possible Refunds of Leasing Fees
- .04 Date for Accrual of Tax Penalties
- .05 Accrual Date for Teacher Salaries Earned in Ten Months but Payable over Twelve Months
- .06 Accrual of Liability under Lawsuit Settlement
- [.07] Reserved

3200 Long-Term Debt

- .01 Classification of Unamortized Bond Discount
- .02 Classification of Discount on Installment Notes to Banks
- .03 Discount on Chattel Mortgage
- .04 Classification of "Add-on Interest"
- .05 Classification of Indefinitely Deferred Payable
- .06 Amortization Period for Placement Fee when Mortgage Refinanced [Amended]
- .07 Calculation of Present Value of an Annuity
- .08 Transfer of Contingently-Held Notes to Capital Surplus
- .09 Financial Statement Presentation of "Pay Any Day" Loans
- .10 Determining the Allocation for Lease Payments for a Lease Capitalized at Fair Market Value

3400 Contingent Liabilities

- .01 Contested Liability
- .02 Disclosure of Agreement Between Corporation and Its Shareholders

3500 Commitments

- .01 Accounting for Contract to Cut Timber
- .02 Liability under Foreign Bank's Letter of Payment Guarantee
- .03 Future Purchases Agreement as an Obligation under Bankruptcy Compromise Agreement
- .04 Recognition of Losses on Purchase Commitments
- .05 Letters of Credit [Amended]
- .06 Covenants Imposed by Loan Agreements [Amended]

3600 Deferred Credits

- .01 Balance Sheet Presentation of Unearned Revenue
- [.02] Reserved

➡ *The next page is 1821.* ⬅

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—Statement on Auditing Standards No. 1, section 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.

.05 Accrual Date for Teacher Salaries Earned in Ten Months but Payable Over Twelve Months

Inquiry—A county board of education engaged a teacher for the school year September to June at an annual salary of \$6,000 payable over a twelve-month period. The board's professional personnel policy states: The annual salary of a teacher is earned in ten equal installments for the months from September through June. The board of education withholds one-sixth of the monthly earnings from each of the ten school months. This makes it possible for the teachers to receive their pay in twelve equal installments.

What amount, if any, should be reflected on the board's balance sheet at June 30 for the \$500 per month payable to the teacher for the months of July and August?

Reply—The wording of the board's professional personnel policies indicates that the annual salary of a teacher is earned for the period September through June even though the salary is paid in twelve equal monthly payments. Accordingly, a teacher

would have fully performed at the end of June and would be entitled to the unpaid balance of his salary at that date, namely, \$1,000. Since this amount is payable within one year from the balance sheet date it should be accrued as a current liability.

.06 Accrual of Liability Under Lawsuit Settlement

Inquiry—Several years ago, Company B instituted legal action against Company A. Under a memorandum of settlement and agreement, Company A agreed to pay Company B a total of \$17,500 in three installments—\$5,000 on March 1, \$7,500 on July 1, and the remaining \$5,000 on December 31. Company A paid the first two installments during its fiscal year ended September 30. Should the unpaid amount of \$5,000 be presented as a current liability at September 30?

Reply—Since the \$5,000 is payable within one year, Company A should present it as a current liability at September 30.

➡ *The next page is 2021.* ←

Section 3200

Long-Term Debt

.01 Classification of Unamortized Bond Discount

Inquiry—What is the proper balance sheet classification of “Unamortized Bond Discount Costs”? Is it an asset or should it be listed as a contra long-term liability account?

Reply—Prior to the issuance of APB Opinion No. 21 in August 1971 it was the usual practice to include such differences between face amount and proceeds of bonds issued among “deferred charges” or “other assets” on the asset side of the balance sheet. Paragraph 16 of Opinion No. 21 changes prior practices; discount should now be shown in the balance sheet as a deduction from the face value of the obligation.

The cost of issuing the debt, on the other hand, represents deferred charges which should still appear on the asset side of the balance sheet.

.02 Classification of Discount on Installment Notes to Banks

Inquiry—Does APB Opinion No. 21 require the discount on installment loans from banks or other credit institutions to be shown on the balance sheet as a reduction of the related debt, or may the discount be shown as a deferred charge?

Reply—Paragraph 16 of Accounting Principles Board Opinion No. 21 states in part:

The discount or premium resulting from the determination of present value in cash or non-cash transactions is not an asset or liability separable from the note which gives rise to it. Therefore, the discount or premium should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit.

There is no reason why this should not be as applicable to installment loans due to banks and other credit institutions as to any other type of debt.

.03 Discount on Chattel Mortgage

Inquiry—Paragraph No. 16 of APB Opinion No. 21 states that a discount resulting from the determination of present value is not an asset separable from the note which gives rise to it and therefore should be reported in the balance sheet as a direct de-

duction from the face amount of the note. Should interest on chattel mortgages included in the face amount of the obligation be given the same statement presentation, since it is of the same nature?

Reply—There is no reason why the unamortized interest on chattel mortgages should be given any different treatment than discount on other obligations. As described in the Opinion, the net liability should be shown at its present value, rather than at the gross amount that would be paid upon maturity.

.04 Classification of "Add-on Interest"

Inquiry—Should installment contracts with add-on interest be presented on the balance sheet as the gross amount of the contract being a liability and the interest being an asset, or should the interest be shown as a deduction from the installment contract amount?

Reply—"Add-on interest" represents a discount on the installments payable and, in accordance with paragraph 16 of APB Opinion No. 21, should be deducted on the balance sheet from the face amount of the obligation. To show such "add-on interest" as an asset would be in violation of paragraph 16.

.05 Classification of Indefinitely Deferred Payable

Inquiry—Under an inventory purchase agreement, payment is deferred provided the purchaser maintains a certain inventory level. The agreement stipulates that title to the goods passes to the purchaser upon receipt of the goods.

Since the inventory will be classified as a current asset, it also seems logical to classify the related liability as current. However, since payment may be indefinitely deferred, classification of the payable as noncurrent can also be justified. Should the payable be classified as a current or noncurrent liability?

Reply—The payable should be classified as a long-term liability. The agreement specifies that title to the goods passes to the purchaser upon receipt. Therefore, the inventory is properly includable as a current asset as if it were being purchased F.O.B. destination under normal credit terms. The deferred payment portion of the agreement is similar to buying a current asset in exchange for a long-term promissory note. Therefore, there is no inconsistency with recording the inventory as a current asset and the payable as a long-term liability.

.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, 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. 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 and FASB Statement No. 4 which deal with early extinguishment of debt. [Amended]

.07 Calculation of Present Value of an Annuity

Inquiry—Appendix C on page 34 of FASB Statement No. 66, *Accounting for Sales of Real Estate*, contains the following calculation:

Present value of 336 monthly payments of	
\$1,583.33 discounted at 8½% (interest rate	
on loan from Insurance Company) (\$1,583.33	
plus \$1,583.33 × 127.9071)	\$204,000

How was this \$204,000 figure reached?

Reply—In this problem, 336 equal monthly installments of \$1,583.33 will be paid. Apparently, the first payment is due immediately, so the present value is calculated as follows:

Present value of first payment:		
(value of one payment due now) ..		\$ 1,583.33
Present value of succeeding 335 payments:		
amount of one payment.....	\$1,583.33	
× present value factor	127.9071	202,519.15
Total present value of 336 payments		<u>\$204,102.48</u>
Rounded as per Guide		<u>\$204,000.00</u>

The present value factor is 127.9071. The factor is for 335 periods at an interest rate of 17/24% per period (8½% per year divided by twelve months per year equals 17/24% per month).

.08 Transfer of Contingently-Held Notes to Capital Surplus

Inquiry—An individual who owns all of the issued and outstanding stock of a corporation agreed to purchase, at a substantial discount from a third party, fully subordinated notes for which his corporation is liable. The notes will be held in escrow by an attorney until the stockholder completes a series of installment payments to the third party. Upon full payment of the installments, the attorney has the right to release the notes. If full payment is not made, the attorney must return the notes to the original holder who will then have recourse to the corporation.

The purchaser of the notes wishes to transfer the notes payable to the capital surplus of the corporation so that, in essence, the obligation by the corporation to the third party would no longer exist. Would this be in accordance with generally accepted accounting principles?

Reply—This transfer should not be effected until the notes are fully paid in accordance with the terms of the agreement. The entire face amount of the notes should be reported as a liability on the corporation's balance sheet, with the installments due in the next fiscal year shown as a current liability, and with adequate footnote disclosure because the corporation remains liable under the terms of the present agreement if the purchaser defaults on the payments.

The transfer of the notes to the corporation's capital surplus would be acceptable if personal assumption of liability for the

notes by the purchaser would induce the original note holder to go without recourse to the corporation.

.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.

»»→ *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 (APB Statement No. 4, Chapter 7, paragraph 199, R 9 A).

➡ The next page is 2571. ←

Section 3500

Commitments

.01 Accounting for Contract to Cut Timber

Inquiry—A client participating in a joint venture is engaged in a forest products operation and purchases considerable quantities of timber from the United States Forest Service. These contracts are shown under deferred liabilities, with the contract account being listed under “timber and development.”

With respect to the timber cutting contracts with the USFS, the venture is obligated to purchase the timber as set forth in the contract, and to construct roads and log the timber in accordance with contract specifications. The venture guaranteed performance by putting up a bond. The Forest Service is not obligated to provide the exact amount of timber set forth in the contract. Total amount of timber finally purchased can vary, not only in footage but in specie. The expected amount of timber by specie is set forth in the contract, and it is this figure that is used in determining the expected total contract obligation. The venture pays only for what the Forest Service delivers. The most common occurrence is for the contract to underrun rather than overrun, in which event, the balance of the expected contract liability would be written off at the termination of the contract.

Is it proper to show the contract as a deferred liability?

Reply—Although it is proper to reflect any advance payments or deposits made in connection with the timber cutting contracts with the USFS, it is improper to reflect the timber cutting contracts (less depletion) as asset and liability unless these contracts, when negotiated, may be deemed to involve a present sale and purchase of the unsevered timber. This latter interpretation is an unlikely one. At the point of contract negotiation, it does not appear that the vendor has set aside or “unconditionally appropriated the goods to the contract.” Growing timber usually does not become personalty until severance. A contract to purchase should be distinguished from a purchase.

Revenue is generally recognized upon the occasion of a “sale,” and the acquisition of an asset is generally recognized and recorded upon the occasion of a “purchase.” In the case in question, it appears the contracts are executory on both sides. It is not generally accepted accounting practice formally to record

commitments in the accounts. However, it is generally accepted practice to adequately disclose the nature and amounts of commitments in the notes to financial statements.

.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.

.03 Future Purchases Agreement as an Obligation Under Bankruptcy Compromise Agreement

Inquiry—A corporation has entered into a compromise agreement with its trade creditors under Chapter XI of the bankruptcy laws. The agreement reduced the corporation's debt to \$1,500,000 to be paid over the next five years. The corporation also agreed with the creditors that future purchases are to be made on a C.O.D. basis, however this provision is not stated in the compromise agreement.

Are the C.O.D. terms an unstated obligation which is to be considered as part of the compromise agreement?

Reply—The auditor should request an opinion from the client's legal counsel regarding whether the C.O.D. terms would be considered as part of the compromise agreement. From an accounting point of view, the C.O.D. terms would not be an unstated obligation in connection with the \$1,500,000 payable. While the major creditors, also the principal material suppliers, continue to do business with the client, the business relationship between the creditors and the client for current purchases is substantially different, and the C.O.D. terms reflect that difference.

.04 Recognition of Losses on Purchase Commitments

Inquiry—Statement 10 of Accounting Research Bulletin No. 43, Chapter 4 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 No. 7.

.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, paragraphs 18-19, 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, SAS No. 32, 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]

➤➤➤➤ ➤ *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.

TIS Section 4000

CAPITAL

TABLE OF CONTENTS*Section*

4100	Capital Stock
4110	Issuance of Capital Stock
	.01 Expenses Incurred in Public Sale of Capital Stock [Amended]
	.02 Stock Issued for No Consideration [Amended]
	.03 Stock Issued for Accounting and Management Services [Amended]
	.04 Stock Issued at Discount to Customers [Amended]
	.05 Restricted Stock Issued to Officer [Amended]
	[.06] Reserved
	.07 Expenses Incurred in Withdrawn Public Offering
	.08 Balance Sheet Presentation of Mandatory Redeemable Preferred Stock
4120	Reacquisition of Capital Stock
	.01 Redeemed Preferred Stock Considered Dividend
	.02 Corporation Buys Out Major Stockholder
	.03 Repurchase of Stock in Excess of Retained Earnings and Additional Paid-in Capital [Amended]
	.04 Reacquisition of Capital Stock Issued in a Pooling of Interests
4130	Warrants
	[.01] Reserved
	[.02] Reserved
	.03 Warrants Reacquired
4140	Stock Options and Stock Purchase Plans
	.01 Measurement of Compensation Cost for Stock Option with Variable Exercise Price
	.02 Disclosure of Stock Option Plan Prior to Measurement Date
	.03 Redemption of Shares Issued Under Employees' Stock Ownership Trust Plan
	.04 Accounting for "Disqualifying Dispositions" of Stock
	.05 Modification of Compensation Cost Under Stock Purchase Plan
	.06 Accounting for Employer's Loan to an Employees' Stock Ownership Plan

Section

- 4150 Stock Dividends and Stock Splits**
- .01 Stock Dividends of Closely-Held Corporation [Amended]
 - .02 Stock Dividend Affecting Market Price of Stock
 - .03 Stock Dividends Without Determinable Market Value
- 4160 Contributed Capital**
- .01 Payment of Corporate Debt by Stockholders [Amended]
 - .02 Forgiveness of Debt by Principal Owner
- 4200 Retained Earnings**
- 4210 Dividends**
- .01 Write-off of Liquidating Dividends
 - .02 Disclosure of Dividends Per Share
 - .03 Undistributed Patronage Dividends of Agricultural Cooperative
- 4220 Quasi-reorganizations**
- .01 Write-up of Assets in Quasi-reorganization [Amended]
 - .02 Combining Paid-in Capital with Operating Deficit in the Absence of Quasi-reorganization
 - .03 Write-off of Accumulated Deficit after Quasi-reorganization [Amended]
- 4230 Capital Transactions**
- .01 Disclosure of Transfer from Retained Earnings to Capital Stock [Amended]
 - .02 Exchange of No Par Common Shares for Par Value Preferred Shares [Amended]
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➡ The next page is 3021. ⬅

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 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]

.04 Stock Issued at Discount to Customers

Inquiry—A corporation has issued some of its stock to one of its substantial customers at a price lower than market value. It is proposed that the stock issue be accounted for at market value and that the excess of market value over cash paid for the stock be shown as an extraordinary charge against income based on the assumption that the discount was given for past services and as an inducement to continue current business relations. There is, however, no agreement binding on the customer to continue doing business with the company.

Is this method of handling the transaction in accordance with generally accepted accounting principles?

Reply—Unless it is evident that no benefit was received by the company for the “bargain” sale of its stock, the transaction should be valued at fair value of such stock at the date the transaction was determined.

In determining the benefit to the corporation of the stock issued, allowance should be made for the fact that issuance of stock normally involves cost, such as registration fees, etc., to the issuer. Thus the net proceeds that might be realized by the client from a sale of stock in the ordinary course of business might well be less than the current market value.

Paragraph 24 of APB Opinion No. 17 states in part, “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.”

The sale of the stock at a “discount” does not meet the criteria for extraordinary items in 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. The discount of the stock, if material, should be shown as a separate item in the income statement as a “special discount granted to a customer” under APB Opinion No. 30, paragraph 26. [Amended]

.05 Restricted Stock Issued to Officer

Inquiry—A closely held corporation issued restricted stock to a new employee during the year in order to induce him to accept employment with the company. The stock issued was one-half voting no-par common stock and one-half nonvoting no-par common stock. The restrictions are to be released in ten equal annual installments. The stock issued was an original issue and all of the stockholders waived their preemptive rights to subscribe to the shares to be issued. The issuance of the stock was recorded on the books of the company as a charge to prepaid expense and a credit to capital stock. The company expects to charge against income, annually, the value, as of the date of issue, of the stock released from the restrictions.

Is this the proper accounting treatment of the stock issued under this restricted stock agreement?

Reply—In accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*, paragraph 14, the unearned compensation should be deducted from stockholders’ equity.

A note to the financial statements should describe the circumstances under which the restricted stock was issued with a brief description of the restrictions. [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—No. 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 stocks are not to be included in amounts reported as stockholders' equity.

Although companies not publicly held are not required to follow Regulation S-X, it would be appropriate for them to do so.

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

This characteristic of equity is not found in mandatory redeemable preferred stock since by its terms it can or must be paid prior to the liquidation of the company.

➡ The next page is 3121. ←

Section 4120

Reacquisition of Capital Stock

.01 Redeemed Preferred Stock Considered Dividend

Inquiry—A client is sole owner of all the preferred and common stock of a corporation. The entire amount of preferred stock was redeemed at par. The client was audited by the Internal Revenue Service and the preferred stock redemption was considered as a preferential dividend. The client had to pay the tax accordingly. Would it be appropriate to set up the preferred stock on the records again?

Reply—This would appear to be a legal, rather than an accounting question. If indeed the preferred stock has not been retired and is still outstanding, the entry showing it to be redeemed should be revised and the correct debit shown, presumably as a dividend. Whether the dividend is on the common or on the preferred stock would also be a legal problem.

.02 Corporation Buys Out Major Stockholder

Inquiry—A corporation had four shareholders—three of the shareholders owning 20% of the stock each, and one shareholder owning 40% of the stock. The three smaller shareholders had the corporation buy out the 40% owner, and these shares are held in escrow. How should this transaction be accounted for?

Reply—Under the laws of many states, a corporation may not pay dividends or purchase shares of its capital stock except out of “available surplus.” In some cases, this may refer to retained earnings only, and in other jurisdictions, to combined additional capital and retained earnings. If the corporation appears to have purchased its own stock in excess of “available surplus,” they should obtain competent legal advice to determine the effect of the transaction on the corporation.

If legal counsel advises that the corporation has indeed purchased its own stock under such conditions, for accounting purposes it should be treated in the same manner as any other purchase of treasury stock in accordance with Chapter 1B of Accounting Research Bulletin No. 43, or, alternatively, in accordance with paragraph 12 of Accounting Principles Board

Opinion No. 6. The total amount expended may be deducted from the total of capital stock, additional capital, and retained earnings; or the par value of the stock purchased may be deducted from capital stock to the extent that it is included therein, and the additional amount may be deducted either entirely from additional capital (to the extent available) or allocated proportionately between additional capital and retained earnings.

.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]

.04 Reacquisition of Capital Stock Issued in a Pooling of Interests

Inquiry—In 1969, Company A exchanged 350,000 shares of its common stock for all the common shares of Company B in a pooling of interests. In 1973, Company A granted an option to former shareholders of Company B to reacquire their shares in exchange

for part of the Company A shares originally issued to them. Under the option agreement, 50,000 of the 350,000 shares originally exchanged were returned to Company A. In contemplation of the option, Company B paid, in cash, all monies due the parent together with a dividend equal to a portion of their retained earnings. What is the proper accounting treatment for the return of Company B to its previous shareholders?

Reply—The return of Company B to its previous shareholders should be accounted for as a sale of the investment in Company B.

➡ *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.

➡ *The next page is 3251.* ←

Section 4140

Stock Options and Stock Purchase Plans

.01 Measurement of Compensation Cost for Stock Option with Variable Exercise Price

Inquiry—A company has a nonqualified stock option plan which has a moving exercise price. Basically, the exercise price decreases from the original option price (equal to market value at date of grant) by \$1.00 for each \$1.00 that market value on the exercise date exceeds market value on the grant date. In no event, of course, is the option price less than zero.

It has been determined that the option is equivalent to compensation and, therefore, an appropriate charge to income should be recorded. The question at issue is how that charge should be determined.

Reply—Measuring compensation is discussed in paragraph 10 of Accounting Principles Board Opinion No. 25, “Compensation . . . should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay.” The definition of measurement date, contained in paragraph 10b of the Opinion, is “. . . the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee. . . . However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after date of grant or award.”

The company’s option plan has a measurement date which would be later than the date of grant or award since the exercise price which the employee pays may decrease from the original option price by \$1.00 for each \$1.00 that market value on the exercise date exceeds market value on the grant date. This type of situation is covered by paragraph 13 of APB Opinion No. 25, which states in part, “If the measurement date is later than the date of grant or award, an employer corporation should record the compensation expense each period from date of grant or award to date of measurement based on the quoted market price of the stock at the end of each period.”

While the first date on which the option price becomes known is the exercise date, the provisions of paragraph 13 cannot be ignored. Paragraph 13 also indicates, "An employee may perform services in several periods before an employer corporation issues stock to him for those services. The employer corporation should accrue compensation expense in each period in which the services are performed." Therefore, compensation related to the stock option plan should be measured, period by period, as the difference between the quoted market price of the stock at the end of each period and the amount which an employee would pay at that date.

.02 Disclosure of Stock Option Plan Prior to Measurement Date

Inquiry—A corporation decided that shares of stock would be issued to an employee for past services when the employee signed a letter of investment intent, and the company and employee agreed on the price at which the stock would be purchased. None of these conditions were met as of the audit date.

How should this be treated in the accounting records, and would this transaction affect earnings per share?

Reply—Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, discusses this topic. The stock to be issued would be under a "compensatory plan." Compensation, if any, would be measured on the measurement date (see paragraph 10). But because the purchase price has not been determined, the "measurement date" has not yet occurred (see paragraph 10b). Therefore, the financial statements should simply disclose the actions taken by the company to date, and there would be no effect on the earnings per share.

.03 Redemption of Shares Issued Under Employees' Stock Ownership Trust Plan

Inquiry—A privately held corporation has an employees stock ownership trust (ESOT) plan. The only investment of the trust is stock of the company acquired either from the company or its shareholders. Participants in the plan may withdraw their proportionate amount of vested shares upon retirement. These shares, can be redeemed either in full or periodically. Legal counsel has determined that under the trust agreement the company has a liability to redeem the shares when there is no market for the shares and the ESOT does not have funds to redeem them.

How should this possible liability be shown on the corporation's financial statements?

Reply—This liability represents a contingent liability requiring footnote disclosure in the financial statements.

.04 Accounting for "Disqualifying Dispositions" of Stock

Inquiry—Must a company account for all "disqualifying dispositions" of shares of stock acquired pursuant to employees stock option plans during 1973 under the requirements of APB Opinion No. 25, *Accounting for Stock Issued to Employees*?

Reply—APB Opinion No. 25, paragraph 20, reads, in part, as follows:

This Opinion applies to all stock option, purchase, award, and bonus rights granted by an employer corporation to an individual employee after December 31, 1972 under both existing and new arrangements . . .

Therefore, if the "disqualifying dispositions" of shares of stock acquired by employees pursuant to a stock option plan during 1973 relate to options granted after December 31, 1972, APB Opinion No. 25 would apply. This may mean that a system needs to be developed by the company which will "track" the early dispositions and provide information which would form the basis of accounting for the "disqualifying dispositions."

.05 Modification of Compensation Cost Under Stock Purchase Plan

Inquiry—The market value of restricted shares of common stock purchased in 1972 under a Key Employee Stock Purchase Plan at a substantial discount has dropped below the original market value of those shares as of the date restrictions on those shares lapse. Could salary expense be reduced to reflect this decline? This would adjust salary expense for the period to correspond with income being recognized for tax purposes upon lapse of restrictions by the shareholders.

Reply—ARB No. 43, Chapter 13B, *Compensation Involved in Stock Option and Stock Purchase Plans*, paragraph 12, states in part, ". . . it follows in the opinion of the Committee that the value to the grantee and the related cost to the corporation of a

restricted right to purchase shares at a price below the fair value of the shares at the grant date may for the purposes here under discussion be taken as the excess of the then fair value of the shares over the option price." ARB No. 43, Chapter 13B does not make any provision for modifying the compensation cost once it has been determined. Therefore, a reduction in salary expense would be inappropriate since, under ARB No. 43, Chapter 13B, once the cost of compensation was determined, it should not be modified even if the market price of the stock dropped substantially. The point that salary expense would correspond with the income recognized by the shareholders is irrelevant since the compensation recognized need not necessarily equal either the income which the shareholder would report for tax purposes or the deduction which the corporation might obtain for tax purposes.

.06 Accounting for Employer's Loan to an Employees' Stock Ownership Plan

Inquiry—The trustees of an Employees' Stock Ownership Plan (ESOP) are negotiating with a bank to borrow funds to purchase stock from its employer sponsor. The bank would grant the loan providing it is guaranteed by the employer sponsor. The employer's controller observed that SOP No. 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*, paragraph 5, would require the employer to record this guarantee as a liability on its balance sheet and paragraph 7 would require the recording of an offsetting debit that would reduce stockholders' equity in its balance sheet. The controller recommended that the employer borrow the funds from the bank and loan it, interest free, to the ESOP. The employer would structure its annual contribution to the ESOP to equal the annual principal portion of the debt service requirement the employer must pay the bank. He concluded that this approach would be reflected in the balance sheet as a receivable from the ESOP and a liability to the bank and there would be no effect on stockholders' equity.

Is this conclusion correct?

Reply—No. The debit should be to stockholders' equity and not to a receivable account. When the ESOP does not have

sufficient assets to meet its debt service requirements, the substance of SOP No. 76-3 would apply whether the ESOP or the employer borrows the funds from the bank. The employer would make the loan payments on behalf of the ESOP or itself regardless of which entity actually borrowed the funds.

»»»→ *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, 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 of Accounting Research Bulletin No. 43, which excludes closely-held corporations from the provisions of paragraph 10.

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 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.” Paragraph 10 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.

.03 Stock Dividends Without Determinable Market Value

Inquiry—A closely-held corporation, the stock of which has no readily determinable market value, issues a stock dividend. How should the stock dividend be accounted for? Could book value per share be capitalized or would this imply that book value equals fair market value?

Reply—Chapter 7B, paragraphs 10 and 12 of Accounting Research Bulletin No. 43 discuss stock dividends. Paragraph 12 states:

In cases of closely-held companies, it is to be presumed that the intimate knowledge of the corporations' affairs possessed by their shareholders would preclude any such implications and possible constructions as are referred to in paragraph 10. In such cases, the committee believes that considerations of public policy do not arise and that there is no need to capitalize earned surplus other than to meet legal requirements.

Therefore, there is no need to capitalize retained earnings except to meet legal requirements. However, if it is decided to capitalize an amount of retained earnings equivalent to the book value per share of the presently outstanding stock, this would not necessarily imply that book value equals fair market value.

»»»→ *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. Footnote 1 to paragraph 20 states, however, that extinguishment transactions between related enterprises may be in essence capital transactions.

»»»→ *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.

.02 Disclosure of Dividends Per Share

Inquiry—A company wants to disclose dividends per share in the financial statements only if required to do so.

Is dividends per share disclosure required under existing pronouncements of the Accounting Principles Board?

Reply—Disclosure of dividends per share is desirable but not required. Paragraph 70 of Appendix A in Accounting Principles Board Opinion No. 15 discusses a situation where dividends per share are disclosed, but there is nothing in the language of that section which indicates that disclosure of dividends per share is a requirement.

.03 Undistributed Patronage Dividends of Agricultural Cooperative

Inquiry—An agricultural cooperative distributed to its members, and certain non-members, patronage dividends partly in the form of “Patronage Refund Certificates.” On subsequent balance sheets, the balance of the patronage refund certificates is listed as a long-term liability. An attorney has suggested, however, that the certificates are subordinate to the general creditors and, therefore, are a hybrid that should be shown as part of equity. How should the patronage refund certificates be classified on the balance sheet?

Reply—The patronage refund certificates should be shown as a separate item in the equity section of the balance sheet, preferably first, since the interest in the cooperative which the certificates represent has characteristics similar to preferred stock.

➡ *The next page is 3601.* ←

Section 4220

Quasi-reorganizations

.01 Write-up of Assets in Quasi-reorganization

Inquiry—A company has a large deficit in retained earnings and shows assets on the balance sheet valued well below market value. Is it permissible under a quasi-reorganization to restate the assets to market value and reduce the deficit?

Reply—The Securities and Exchange Commission includes the following definition of a quasi-reorganization in its Codification of Financial Reporting Policies, Sec. 210 (ASR 25):

. . . a quasi-reorganization has come to be applied in accounting to the corporate procedures in the course of which a company, without the creation of a new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or the recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization.

Another paragraph in this section includes the following:

It has been the Commission's view for some time that a quasi-reorganization may not be considered to have been effected unless at least all of the following conditions exist:

. . . The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

Paragraph 17 of Accounting Principles Board Opinion No. 6 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."

Codification of Financial Reporting Policies, Sec. 210 (ASR 25) and ARB No. 43, Chapter 7A, sanction revaluing the assets

of an entity to effect a quasi-reorganization if the revaluations result in a net write-down of the assets, not a net write-up.
[Amended]

.02 Combining Paid-in Capital With Operating Deficit in the Absence of Quasi-reorganization

Inquiry—A company, whose balance sheet shows an operating deficit, feels that bankers find this confusing, since they may not take into consideration the fact that the company does have a positive net worth after adding together paid-in capital, capital stock, and operating deficit. Would it be permissible to combine paid-in capital with the operating deficit and show only capital stock and retained earnings on the balance sheet?

Reply—It would not be appropriate to combine paid-in capital with the operating deficit in the absence of a quasi-reorganization. "Operating capital" should be disclosed separately from contributed capital.

Accounting Research Bulletin No. 43, Chapter 7A; ARB No. 46; and Accounting Research Study No. 15 discuss transfers of retained earnings.

.03 Write-off of Accumulated Deficit After Quasi-reorganization

Inquiry—A corporation underwent a Chapter XI reorganization several years ago. At that time, the accountants carried forward the retained earnings (deficit), paid-in capital, and common stock instead of starting a new reorganized corporation with a zero retained earnings.

The stockholders have now approved a change in the capital section which will write off the paid-in capital against the retained earnings (deficit). The change will be footnoted in the year-end financial statements and will be labeled "deficit remaining after application of paid-in capital to retained earnings." The new deficit or paid-in capital arising after this date will be labeled accordingly.

Is this procedure acceptable?

Reply—Chapter 7A of Accounting Research Bulletin No. 43 reaffirms the rule adopted by the Institute in 1934 which reads as follows:

Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to

the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

Paragraph 9 of Chapter 7A states “When the readjustment has been completed, the company’s accounting should be substantially similar to that appropriate for a new company.”

Examples of quasi-reorganizations in which the full amount of the deficit in retained earnings has not been eliminated are unusual. Further, the SEC, in Sec. 210 (ASR 25) of its Codification of Financial Reporting Policies, has stated that it will not recognize a “quasi-reorganization” if the resulting statement of financial position shows a debit balance in any stockholders’ equity account.

Therefore, a transfer of the deficit account to paid-in capital would only be appropriate in the case of such a “quasi-reorganization.” Furthermore, because there was an excess of liabilities over capital, the company cannot adjust its accounting so that it will be “substantially similar to that appropriate to a new company,” and therefore it cannot be considered a “quasi-reorganization” as contemplated in Chapter 7A.

As the creditors of the company in fact hold, at present, the “equity interest” in this company, they might be willing to convert some of their present “debt” to equity, thus permitting the formation of sufficient capital to allow write-off of the full deficit.

Any such quasi-reorganization should only be attempted on advice of counsel. [Amended]

➡ *The next page is 3631.* ←

Section 4230

Capital Transactions

.01 Disclosure of Transfer from Retained Earnings to Capital Stock

Inquiry—The board of directors of a client authorized the transfer of \$1,000,000 to its no par capital stock account from retained earnings. How should this transfer be disclosed in the financial statements?

Reply—AICPA Accounting Research Study No. 15, *Stockholders' Equity*, by Beatrice Melcher (1973), discusses, on pages 67-68 other transfers between components of stockholder's equity, and states that:

State corporate laws permit properly authorized transfers between legal components of stockholders' equity in addition to those for stock splits and changes in par or stated value of stock. Transfers may encompass many arbitrary changes in equity components. Customarily, retained earnings is reduced and capital stock or capital in excess of par or stated value is increased the same amount. Sometimes, either of the contributed equity components is reduced and retained earnings increased provided appropriate documents are filed with the state of incorporation.

In this situation, footnote disclosure in the year in which the transfer takes place would meet the requirements for adequate disclosure. Also, the auditor may wish to prepare and maintain in his permanent file a workpaper schedule which indicates the original invested capital and subsequent transfers from retained earnings. [Amended]

.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]

TIS Section 5000

REVENUE AND EXPENSE

TABLE OF CONTENTS

Section

5100

Revenue Recognition

- .01 Equipment Sales Net of Trade-Ins
- .02 Rights to Broadcast Time Received in Exchange for Services
- [.03] Reserved
- .04 Discounts on Prepaid Funeral Arrangement Plans
- .05 Accrual Date for Property Taxes
- .06 Free Goods or Services as Inducement for Signing Contract
- .07 One-Cent Sales
- .08 Life Membership Fees in a Club
- .09 Membership Dues Applicable to an Indefinite Term [Amended]
- .10 Members of Country Club Assessed for Debt Retirement
- .11 Excise Tax on Club Dues
- [.12] Reserved
- [.13] Reserved
- .14 Recognition of Fees Earned on Construction Mortgage Placements
- [.15] Reserved
- .16 Rental Revenue Based on Percentage of Sales
- [.17] Reserved
- [.18] Reserved
- .19 Sale of Partially Completed Goods
- .20 Payment for Termination of License Agreement
- .21 Retirement Home Admittance Charges
- .22 Rental of Equipment to Residents of Home for the Aged
- .23 Revenue from Agreement Not to Compete
- .24 Discounts on Loans Receivable of Small Business Investment Company [Amended]
- .25 Finished Parts Held by Manufacturer for Customers
- [.26] Reserved
- .27 Fees for Obtaining Contracts for Others
- .28 Revenue from Private Label Sales [Amended]
- .29 Gain from Transfer of Assets in Debt Restructuring
- .30 Wash Sale of Securities by a College
- .31 Accounting for Zero Coupon Bonds

5200 Expenses

5210

Depreciation and Depletion

- .01 Change in Depreciation Method for Newly Acquired Assets
- .02 Disclosure of Depreciation Expense
- .03 Depreciation Method for Appliances in Apartment Building
- .04 Depreciation of Clothing Rented to Individuals
- .05 Classification of Costs of Constructing a Golf Course

Section

5210	Depreciation and Depletion—Continued
	.06 Discontinuation of Depreciation on Demolished Hospital Building
	.07 Relationship of Accelerated Cost Recovery System to Generally Accepted Accounting Principles
	.08 Additional First Year Depreciation
	.09 Amortization of Leasehold Improvement
 5220	 Interest Expense
	.01 Deferral of Payment of Interest
	.02 Interest on Mortgage Note Related to Cost of Living Index
	.03 Computation of Interest Expense on Long-Term Redeemable Bonds
	.04 Discounting Small Business Administration Disaster Relief Loans
	.05 Amortization of Prepaid Interest on Discounted Notes
	.06 Imputed Interest on Shareholder Loans
 5230	 Employee Benefit Plans
	[.01] Reserved
	[.02] Reserved
	.03 Spreading Actuarial Gains and Losses
	[.04] Reserved
	[.05] Reserved
	.06 Deferred Compensation Payable to Surviving Spouse
	.07 Deferred Compensation Benefits to Key Personnel
	[.08] Reserved
 5240	 Cost Allocation
	.01 Transfer Pricing Between Manufacturing Division and Selling Division
	[.02] Reserved
	.03 Research and Development Costs Incurred by a Development Stage Enterprise
	.04 Research and Development Costs for Internally Developed Patents
	.05 Research and Development Costs as an Element of Factory Overhead [Amended]
	.06 Expansion of an Established Enterprise
	.07 Computer Software Development Costs
	.08 Organization Costs [Amended]
 5250	 Tax Allocation
	.01 Balance Sheet Classification of Deferred Taxes—I [Amended]
	.02 Balance Sheet Classification of Deferred Taxes—II [Amended]
	.03 Income Statement Presentation of Operating Loss Carryback
	[.04] Reserved
	.05 Realization of Tax Benefit of Loss Carryforward

Section

- 5250 Tax Allocation—Continued**
- .06 Tax Effect of Permanent Tax Differences in Business Combination
 - .07 Tax Effect of Undistributed Earnings of Newly Acquired Subsidiary
 - .08 Intercompany Tax Allocation for Consolidated Companies
 - .09 Tax Allocation Among Subsidiaries of Public Utility Holding Company
 - .10 Shipbuilders' Capital Construction Reserve Funds [Amended]
 - .11 Accounting for New Jobs Credit
 - .12 Effect of Loss Carryforwards on the Recognition of Investment Tax Credits
 - .13 Amount of Operating Loss Carryforward Recognized
- 5260 Estimated Losses**
- .01 Recognition of Estimated Losses on Uncompleted Contracts
- 5290 Other Expenses**
- [.01] Reserved
 - .02 Classification of Expenses Which Are Taxable to Employees
- 5300 Prior Period Adjustments**
- .01 Correction of Error
- 5400 Extraordinary Items**
- .01 Loss on Abandonment of Sales Project
 - .02 Sale of Cotton Futures Commitment Contracts
 - .03 Gain on Involuntary Conversion
 - .04 Reporting the Proceeds From Life Insurance on an Officer
- 5500 Earnings Per Share**
- .01 Earnings Per Share on Combined Financial Statements
 - .02 Earnings Per Share of Wholly-Owned Subsidiaries
 - .03 Weighted Average Shares Outstanding for an Interim Period
 - .04 Earnings Per Share for Two Classes of Common Stock
 - .05 Earnings Per Share with Contingently Convertible Class B Stock
 - .06 Earnings Per Share with Cumulative Preferred Stock
 - .07 Earnings Per Share with Noncumulative Preferred Stock
 - .08 Callable Debentures in Determining Shares Outstanding
 - .09 Conversion Price of Debentures for Computing Fully Diluted Earnings Per Share
 - .10 Convertible Debentures Held by Federal Government
 - .11 Warrants Outstanding for Less than Three Months
 - .12 Five Year Options as Common Stock Equivalents
 - .13 Shares Held as Collateral Under Subscription Agreement

Section

5500

Earnings Per Share—Continued

- .14 Net Loss Per Share with Subsequent Granting of Stock Options
- .15 Stock Dividend Declared But Not Paid at Balance Sheet Date
- .16 Indeterminate Value of Stock of Closely Held Company

5600

Leases

- .01 Fee Received by Lessor for Assignment of Lease
[Amended]
 - .02 Lease Between Related Parties
 - .03 Accounting for "Free Rent" and Scheduled Rent Increases
Under an Operating Lease
-

➡ The next page is 3921. ←

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 in Exchange for Services

Inquiry—A company which provides services to radio and television stations, such as station identifications and jingles, receives broadcast time credit as part payment. Should this time credit be realized when it is subsequently sold to advertisers, when the credit is received, or when the time is actually used?

Reply—The broadcast time credit the company receives as part payment for the services it has performed should be accounted for as income at the time the services are rendered with a correlative debit to an asset account. When this time is subsequently sold by the company to an advertiser, a gain or loss on this transaction should be recorded.

.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 with-

drawals 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.

.05 Accrual Date for Property Taxes

Inquiry—Prior to 1975, a county government had a year end of December 31. In 1975, the fiscal year was changed to June 30 creating a problem with the recognition of property tax revenue. The following facts are pertinent:

- (1) A full accrual system is used.
- (2) In prior years all tax revenue was recognized at December 31. The tax digest is prepared in August and the tax collection period is October-December with assessment date being January 1 of the same year.

At June 30, 1975, should one-half of the taxes receivable be recognized as revenue and one-half treated as unearned income?

Reply—Since the assessment date is January 1 of each year, but the actual tax roll is not completed until August and collections are made during the fourth quarter of the calendar year, it appears that the taxes receivable can not be determined until the end of August. Therefore, the financial statements prepared for the six months ended June 30, 1975, should show income for one-half the estimated taxes to be collected for the year. The corresponding asset might be described as “unbilled taxes (representing one-half the estimated taxes for the calendar year 1975)” or some similar caption.

.06 Free Goods or Services as Inducement for Signing Contract

Inquiry—A client is engaged in the sale of fuel oil to customers. In order to acquire new customers, service contracts are offered for two or three years with the first year free of cost. Which of the following two methods is appropriate accounting for free services?

Under one method, the total proceeds from the sales of service contracts are allocated over the entire length of the contract, including both the paid service and free service terms. Under this method the revenues from sales of service contracts would be recorded at a discount price over the entire term. The cost of servicing the customer's equipment is charged out as it is incurred. The justification for this method is that the customer will be purchasing fuel oil during this entire term; therefore, this is a proper matching of costs and revenues.

Under the second method, upon the sale of a service contract which includes an element of free service, a sales expense account

would be debited for the portion of the contract representing free service and deferred service contract income would be credited for the "list price" of the contract. This deferred credit would then be amortized over the life of the contract. This method considers the free service as a sales expense in acquiring new business. The cost of providing the service is, as in the first method, charged out as it is incurred.

Reply—The first method is the proper one to be followed. The customer is paying X dollars for a contract that runs for a specific number of years. This situation is no different from one in which the purchaser of a package of five cigars gets an additional one "free." The purchaser is essentially paying a certain amount of money for six cigars.

The second method introduces a fictitious sales expense into the accounts with a correlative fictitious deferred income.

.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 client 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.

.09 Membership Dues Applicable to an Indefinite Term

Inquiry—A client sells memberships in a “club” type of organization, with membership dues charged as follows:

- (1) \$39 down and \$19 per month for 24 months for a total of \$495, or
- (2) A flat fee of \$456.

The financed contracts are sold to finance companies, which withhold \$80 in finance charges and \$50 in reserve pending fulfillment of the contract. The client, upon sale of the contract, receives \$326 plus the original down payment of \$39, or \$365. The membership contract is called a non-expiring benefit agreement and entitles the member to purchase appliances, furniture, carpeting, etc. at a discount price plus 6% for handling and warehouse charges.

The membership fees are forfeitable three days from receipt, and any additional contemplated costs are covered by the 6% handling and warehouse charge.

When is income earned in these transactions?

Reply—FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 84, states in part:

“In recognizing revenues and gains:

- a. The two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery).
- b. If sale or cash receipt (or both) precedes production and delivery (for example, magazine subscriptions), revenues may be recognized as earned by production and delivery.

- c. If product is contracted for before production, revenues may be recognized by a percentage-of-completion method as earned—as production takes place—provided reasonable estimates of results at completion and reliable measures of progress are available.
- d. If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes.”

The membership fees should be deferred and recognized as income on the basis of the passage of time or use of the service; the specific allocation basis being a matter of judgment as to the appropriate time period since the memberships have no specific expiration dates. [Amended]

.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 Place-ments

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—APB Statement No. 4, paragraph 148, states in part:

Revenue under present generally accepted accounting principles is derived from three general activities:

- (a) selling products,
- (b) rendering services and permitting others to use enterprise resources, which result in interest, rent, royalties, fees, and the like, and
- (c) disposing of resources other than products—for example, plant and equipment or investments in other entities.

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.

.19 Sale of Partially Completed Goods

Inquiry—Under an agreement with a customer, a company will manufacture a product to a certain stage of completion. The company will hold the unfinished product and bill the customer for 65% of the selling price of finished products. The company contends that sales occur when the merchandise is produced to the stage indicated in the agreement and the customer is billed. Is this contention correct?

Reply—If the customer is obliged to accept the 65%-completed product, there is justification for treating the transaction as a sale at the time the merchandise is produced to the stage indicated, set aside, and billed.

.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 patents 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.

.21 Retirement Home Admittance Charges

Inquiry—A nonprofit home for the aged imposes an admittance charge. The admittance charges in this, the first year of operation, are considerably more than anticipated for future years. The home incurs expenses for screening and medical examinations of the residents amounting to approximately 15% of the admittance charge. These admittance expenses are offset against the admittance charge, and the net amount is shown as deferred income. Is this treatment in accordance with generally accepted accounting principles?

Reply—Since there are no plans to refund any portion of this charge, and since it is meant to cover only the expenses incident to screening and admitting prospective residents, it would seem that upon completing the screening process and admitting the resident, the home has done everything required to “earn” the charge, and, accordingly, should reflect it as earned during the current period.

Offsetting the screening and medical expenses against the admittance charge and carrying forward the net amount is not in conformity with generally accepted accounting principles.

.22 Rental of Equipment to Residents of Home for the Aged

Inquiry—A nonprofit home for the aged receives donations of equipment. The equipment is then sold to the residents at its retail value. If the resident leaves during the first year of using the equipment, 75% of the cost is refunded; during the second year, 50% of the cost is refunded; and if he dies at anytime or leaves after the second year, no refund is made. What is the proper method of handling this item?

Reply—It is questionable whether the “sales” of the equipment to the residents are properly construed as sales; they are more in the nature of bailments or rental arrangements, since if the resident leaves the home during the first or second year following his “purchase,” he receives a partial refund, but if he should die during this period or leave after two years, he does not get any refund. Nor does he, by implication, have the right to have “his” equipment included in his estate, or take it with him should he leave. Consequently, unless it can be said that title actually vests with the resident, and that he may do as he pleases with the equipment at any time, the amounts so received should be treated as equipment rental income. Accordingly, if material, 25% of such rental fee should immediately be recognized as income, and the remaining 75% deferred. At the beginning of the second year of use, another 25% of the original total should be taken up as income. The remaining 50% should be transferred to income at the beginning of the third year of use. Of course, in the event the resident dies, any balance in his deferred equipment rental account would be transferred to current income.

.23 Revenue from Agreement Not to Compete

Inquiry—Company A sold its 60% interest in Company B to

the other stockholders of B. As a part of the contract, the shareholders of Company B agreed to pay a certain amount to Company A under a noncompetition agreement lasting three years. The amount is to be paid to Company A equally over this three-year period. When does Company A recognize the amount as income, at the time of signing the contract, or $\frac{1}{3}$ in each year? Also, would it make any difference if a note was given by Company B stockholders to Company A paying $\frac{1}{3}$ of the amount in each of the three years?

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

“If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes.”

Since Company A has agreed not to compete for three years, it in effect is performing a “service” for the buyers by not competing. Therefore, the income from the agreement not to compete should be recognized ratably over the three-year period. If a note was received for the amount, the note would be recorded when received and a deferred credit would be set up for the income, which would then be recognized over the three-year period.

.24 Discounts on Loans Receivable of Small Business Investment Company

Inquiry—When should a Small Business Investment Company recognize, as income, a nonrefundable discount that the borrower pays to the company?

Reply—The Small Business Administration Act—System of Account Classification for SBIC’s, effective December 1, 1974, covers unearned discount, fees, and other charges on loans. The regulations provide that the discount is earned either through collection or passage of time. [Amended]

.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.

.27 Fees for Obtaining Contracts for Others

Inquiry—Corporation B performs engineering services for a fee to assist contractors or subcontractors in obtaining contracts. Prior to negotiations between a contractor or subcontractor and a prospective client, the contractor or subcontractor signs a letter of intent with B agreeing, subject to obtaining the contract, to pay B a fee. When the contractor or subcontractor signs a contract with a client, it becomes legally obligated to pay B's fee. B does not receive its fee until the contractor or subcontractor collects the total contract price. When should B record a fee as income?

Reply—APB Statement No. 4, paragraphs 150-153, discuss revenue recognition. Paragraph 150 states:

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.

Accordingly, B should recognize a fee as revenue when a contractor or subcontractor signs a contract with a client because that is the date (as indicated in the *Inquiry*) that B is legally entitled to receive its fee.

.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]

.29 Gain from Transfer of Assets in Debt Restructuring

Inquiry—Company A transfers assets carried at \$15,000 (fair value is \$20,000) to Company B to pay a note of \$25,000. How should Company A report the gain on restructuring of payables?

Reply—The difference of \$5,000 between the fair value of the assets transferred and the amount payable would, if material, be classified as an extraordinary gain in accordance with FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, paragraphs 13 and 21. The other difference of \$5,000 between the carrying amount of the assets and its fair value would be a gain on transfer as stated in FASB Statement No. 15, paragraph 14. The gain would be reported 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*, which states that an event or transaction is not extraordinary unless it meets both of the criteria defined in the Opinion.

.30 Wash Sale of Securities by a College

Inquiry—A private college owned readily marketable equity securities that reflected a substantial unrealized appreciation. The college sold the securities and recorded a gain of over \$500,000. On the next day the college purchased for the same price the same type securities.

Does this constitute a wash sale for which no gain should be recognized?

Reply—It should be considered a wash sale and no gain should be recorded. There was no economic substance to this transaction.

The AICPA Industry Audit Guide, *Audits of Colleges and Universities*, does not address this matter. However, the AICPA Industry Audit Guide, *Audits of Banks*, Chapter 5, page 33, discusses wash sales and states that:

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 increased 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.

.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 $4\frac{1}{4}\%$ (half of $8\frac{1}{2}\%$) 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.

➤ The next page is 4121. ⬅

Section 5210

Depreciation and Depletion

.01 Change in Depreciation Method for Newly Acquired Assets

Inquiry—A company followed the straight-line depreciation method for a particular class of assets. Recently the company began depreciating newly acquired assets of this class on an accelerated basis, but the old assets remain on the straight-line method. Is this a change in an accounting principle as defined in Accounting Principles Board Opinion No. 20?

Reply—Paragraph 24 of APB Opinion No. 20, *Accounting Changes*, states:

For example, a company may adopt a new method of amortization for newly acquired, identifiable, long-lived assets and use that method for additional new asset of the same class but continue to use the previous method for existing balances of previously recorded assets of that class. For that type of change in accounting principle, there is no adjustment of the type outlined in paragraphs 19-22, but a description of the nature of the change in method and its effect on income before extraordinary items and net income of the period of the change, together with the related per share amounts, should be disclosed.

Therefore, the change described would represent a change in accounting principle, subject to the treatment described in Section 420.06 of Statement on Auditing Standards No. 1 and APB Opinion No. 20.

.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?

Appendix A, part D of APB Opinion No. 11 discusses depreciation “recorded in accounts.” Is APB Opinion No. 11 referring to depreciation expense or to the depreciation accrual?

Reply—In concerns such as public utilities and trading or commercial enterprises, determination of the total provision for de-

preciation 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.

The same rationale would apply to "depreciation recorded in accounts."

.03 Depreciation Method for Appliances in Apartment Building

Inquiry—What is the prevailing accounting treatment with regard to the acquisition and depreciation of stoves, refrigerators and like items for residential apartment buildings?

Reply—Although it was not possible to determine whether there is any one prevailing accounting treatment regarding the acquisition and depreciation of stoves, refrigerators and like items for residential apartment buildings, the use of the composite rate method of accounting for the depreciation of these items seems to be most practicable. This method works well where the items under consideration have reasonably determinable useful lives, and assumes that those items which remain in use past the average useful life will be offset by those which are retired

within a below-average period of time. By maintaining only one group account, recurring and numerous purchases present minimal bookkeeping problems, and considerable time is saved. When an asset which is included in the group is purchased, the composite cost account is increased, and when an asset of the group is retired, its cost is charged to the allowance for depreciation account and credited to the composite cost account. Ordinarily, no gain or loss is recognized in the accounts upon early retirement.

.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.

.06 Discontinuation of Depreciation on Demolished Hospital Building

Inquiry—A tax-exempt hospital demolished a building constructed five years ago at a cost of \$200,000. This resulted in a loss.

Since third parties reimburse the hospital for depreciation, should the demolished building remain on the books and be depreciated as if it were still in existence?

Reply—Since the building no longer exists, it is unreasonable and improper to continue to carry the building on the books and take depreciation. The demolition of the building resulted in a loss which should be reflected in the accounts.

.07 Relationship of Accelerated Cost Recovery System to Generally Accepted Accounting Principles

Inquiry—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 tax purposes 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.

May the recovery deductions used for income tax purposes also be used as depreciation expense for financial reporting purposes?

Reply—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 timing differences that result, as required by APB Opinion Nos. 1 and 11. (See *The CPA Letter* of November 23, 1981.)

.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 \$5,000 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, paragraph 9, states, in part: “. . . depreciation accounting, a system which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit . . . in a systematic and rational manner. . . .” Accordingly, if an arbitrary additional first year depreciation amount is included in the financial statements and it is material, it would be a departure from generally accepted accounting principles. Refer to SAS No. 2, paragraph 16, and SAS No. 47, paragraph 6, for guidance on materiality.

Obviously, if the financial statements were prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, for example, the income tax basis of accounting, there would not be a departure from that basis.

.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 build-

ing, 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?

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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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% to 8%, but the lender has the option in the future of increasing the interest rate to 11% to recover the foregone interest. At the maturity date, any unpaid interest calculated at the original 10% 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%, 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% rate) and noncurrent liabilities (an amount representing the "deferred interest").

.02 Interest on Mortgage Note Related to Cost of Living Index

Inquiry—A mortgage note contains a provision under which the amount of monthly payments increases if there is an increase in the Cost of Living Index. Should the increase in monthly payments be considered as additional interest or allocated to principal and interest?

Reply—The increase in monthly payments should be considered 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% for the first year, 7½% for the second year, 8% for the third year and 8½% 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% 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% for the first year, 7½% for the second year (plus the compounding factor), 8% for the third year (plus the compounding factor), and 8½% 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.

.04 Discounting Small Business Administration Disaster Relief Loans

Inquiry—Under its disaster relief program, the small Business Administration makes loans at a 1% interest rate to individuals or companies that suffered financial losses from natural disasters. In financial statement presentation, should these loans be discounted to the present value, or is this the type of loan that is discussed in paragraph 3 of Accounting Principles Board Opinion No. 21?

Reply—Paragraph 3(e) of APB Opinion No. 21, *Interest on Receivables and Payables*, indicates that the Opinion does not apply to “transactions where interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (e.g., industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlements)....” Therefore, SBA loans of this type would not have to be discounted to present value by using an imputed interest rate.

.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 as de-

scribed in APB Opinion No. 11, *Accounting for Income Taxes*, paragraph 33.

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Section 5230

Employee Benefit Plans

.03 Spreading Actuarial Gains and Losses

Inquiry—A corporation wishes to clarify the accounting for cost of pension plans. Can the use of the “unit credit method” accomplish the spreading of actuarial gains or losses as described in APB Opinion No. 8, paragraph 27?

Reply—In discussing the “unit credit method” in paragraph 27, it is indicated that the actuarial gains “reduce the maximum pension costs deduction for the year of occurrence or the following year.” This reduction would not accomplish the spreading of actuarial gains and losses as discussed in paragraph 30. In the sentence which reads, “If this is not accomplished through the routine application of the method (for example, the unit credit method—see Paragraph 27) . . .,” the unit credit method is being cited as an example which does not accomplish the necessary spreading, and therefore a separate adjustment would be required. AICPA Interpretation No. 13 of APB Opinion No. 8 discusses actuarial gains and losses further.

.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, 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.

.07 Deferred Compensation Benefits to Key Personnel

Inquiry—Corporation A has contracted with individual employees to provide them with the following deferred compensation benefits:

1. To pay a specified amount for life, beginning at age 65.
2. To continue reduced payments to the employee's spouse for a guaranteed number of years if the employee dies after retirement but before receiving 120 monthly payments.
3. To pay a death benefit to the spouse or the employee's dependent children if the employee dies before retirement.

Corporation A has purchased life insurance policies (whole life and supplemental annuities) for 50% of the liability to each employee. The cash surrender value of the policies on employees who terminate their employment before retirement will be invested to provide a fund to pay the employees who will ultimately receive benefits under the plan. Operating revenue will be used to pay the benefits if the fund proves to be inadequate.

Twenty-five percent of Corporation A's employees are included in the described benefit program. How should the annual expense for the program be determined?

Reply—The benefit program appears to be a pension and insurance plan as defined in APB Opinion No. 8. The annual costs to be accrued would represent a combination of the insurance premiums to be paid, as discussed in APB Opinion No. 8, paragraph 41, and the actuarial costs of the remaining 50% of the estimated liability based on actuarial factors.

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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.

.03 Research and Development Costs Incurred by a Development Stage Enterprise

Inquiry—What is the appropriate accounting for research and development costs incurred by a company in the development stage?

Reply—FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, concludes that no special accounting standards shall apply during the development stage. If the financial statements purport to be presented in accordance with generally accepted accounting principles, research and development costs should be charged to expense as incurred, in accordance with FASB Statement No. 2, *Accounting for Research and Development Costs*.

.04 Research and Development Costs for Internally Developed Patents

Inquiry—Corporation A engages in research and development activities as defined in Financial Accounting Standards Board Statement No. 2. Corporation A has incurred costs for drawings, experimental models, development work, and for fees payable to governmental agencies and attorneys related to projects for which patents are pending or have been obtained. Should these costs be deferred or expensed?

Reply—The costs for drawings, experimental models, and development work are research and development costs as defined in FASB Statement No. 2 and should be recorded as expenses at the date incurred. The fees to governmental agencies and attorneys are not research and development costs as defined in Statement No. 2 and may be accounted for as costs of patents.

.05 Research and Development Costs as an Element of Factory Overhead

Inquiry—Can research and development costs be an element of factory overhead?

Reply—No. FASB Statement No. 2, *Accounting for Research and Development Costs*, provides that all research and development costs be charged to expense when incurred. Including research and development costs as an element of factory overhead would result in partially deferring these costs because factory overhead is allocated to inventory. [Amended]

.06 Expansion of an Established Enterprise

Inquiry—Does FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, apply to an established operating enterprise that is expanding?

Reply—FASB Statement No. 7, paragraph 8, gives criteria for identifying a development stage enterprise. It states that “. . . an enterprise shall be considered to be in the development stage if it is devoting substantially all of its efforts to establishing a new business . . .” and either planned principal operations have not started, or if they have started the revenue from them has not been significant. Thus, the Statement does not apply to an established operating enterprise which is expanding.

.07 Computer Software Development Costs

Inquiry—Should a company capitalize or expense costs incurred in developing computer software for a general management information system to be used within the company?

Reply—Practice varies in accounting for the costs to develop computer software for general management information systems. Most companies expense the costs as incurred, but some companies capitalize the costs and amortize them over the expected future period to be benefited.

Costs of software for a general management information system are excluded from research and development costs as indicated in FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*, paragraph 4.

.08 Organization Costs

Inquiry—Corporation A incurred costs to organize an entity, obtain bank financing, construct a facility and begin manufacturing operations. These costs, classified as organizational expenses, include:

- Legal costs to incorporate and establish the company
- Accounting fees to prepare the initial projections and reports required for procuring the necessary equity financing
- Travel costs and monthly salary costs of the president to secure financing, oversee construction and establish business relationships for future business
- Payroll costs for employees who were assisting in preparing the plant for a condition of readiness for operations

What is an appropriate accounting treatment for such costs?

Reply—The accounting for organization expenses is not addressed in the authoritative literature. *Kohler's Dictionary for Accountants* defines organization cost as any cost incurred in establishing a corporation or other form of organization. Included in organization costs are incorporation, legal and accounting fees. Generally, immaterial organization costs are amortized over a short period of time, usually three to five years. Some accountants believe that these costs coupled with promotional fees and printing costs incurred to solicit equity financing should be considered issue costs and, if material, would be charged to paid-in capital when proceeds from the sale of capital stock are received.

FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, defines a development stage enterprise and states that a development stage enterprise will typically devote much of its efforts to financial planning, raising capital, acquiring assets, developing markets and starting up production. Paragraph 10 states that generally accepted accounting principles that apply to established enterprises also apply to development stage enterprises and will determine whether a cost incurred is to be charged to expense or capitalized.

Travel costs and salary expenses relating to the construction of assets, preparation for their use and establishment of business relationships do not constitute organization or issue costs and should be reported in accordance with FASB Statement No. 7, paragraph 10, as indicated in the immediately preceding paragraph. [Amended]

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Section 5250

Tax Allocation

.01 Balance Sheet Classification of Deferred Taxes—I

Inquiry—A company finds it advantageous to report its income on the cash basis for tax purposes because uncollected income (receivables) can be expected to exceed unpaid expenses (payables) each year. If the company continues to grow and remains profitable, the timing differences between tax and accounting income can be expected to not reverse in the near future, and the deferred tax liability may even grow from year to year. Since the company will not realize the effects of this deferred liability for taxes until some indefinite time in the future, why should the deferred taxes be classified on the balance sheet as a current liability?

Reply—In accordance with paragraph 57 of APB Opinion No. 11, as amended by paragraph 4 of FASB Statement No. 37, deferred taxes which relate to current assets and current liabilities should be classified as a current liability.

Although the balance in the deferred tax account may indeed increase from year-end to year-end, its individual components reverse each year, as the prior year's receivables are collected and the accruals paid. Thus, part of each year's tax payment results from transactions recorded on the books in prior years, and transactions of the current year result in new deferred taxes.

To remove such deferred taxes from current liabilities because the amount thereof increases from year to year seems no more justifiable than it would be to remove from current assets the corresponding receivable because the amount thereof continues to increase from year to year and is therefore never "collected." [Amended]

.02 Balance Sheet Classification of Deferred Taxes—II

Inquiry—A contractor is on the cash basis for income tax purposes but prepares financial statements on the accrual basis. As a result, there are timing differences due to the revenue from accounts receivable not recorded for tax purposes and expenses relating to accounts payable which are not deducted on

➡ The next page is 4411-3. ⬅

the income tax returns. Income taxes resulting from the timing difference and income taxes on the accrual basis income are shown as separate captions in the income statement. Related deferred taxes are shown on the balance sheet as a current liability. This treatment has a material effect on working capital, which is important to the contractor for bonding purposes and also for pre-qualification with various governmental agencies. What is the proper balance sheet classification for the deferred taxes?

Reply—Paragraph 57 of APB Opinion No. 11, as amended by paragraph 4 of FASB Statement No. 37, states in part, “deferred charges and deferred credits relating to timing differences . . . should be classified in two categories—one for the net current amount and the other for the net noncurrent amount. . . . A deferred charge or credit that is related to an asset or liability shall be classified as current or noncurrent based on the classification of the related asset or liability. A deferred charge or credit that is not related to an asset or liability because (a) there is no associated asset or liability or (b) reduction of an associated asset or liability will not cause the timing difference to reverse shall be classified based on the expected reversal date of the specific timing difference.

Thus if the only difference between income tax reporting and the financial statements results from recording current accounts receivable and accruing current liabilities, the full credit for deferred income taxes should be included in current liabilities. To the extent that the difference between tax reporting and the financial statements is reflected in depreciation, in noncurrent receivables, or in other noncurrent assets, it would be appropriate to classify deferred taxes resulting therefrom as a noncurrent deferred credit. [Amended]

.03 Income Statement Presentation of Operating Loss Carryback

Inquiry—What is the proper income statement presentation of income tax credits resulting from an operating loss when extraordinary gains exceed this loss? The situation of a client is as follows:

1. Current year's operating loss equals \$100,000.
2. Extraordinary gains equal \$200,000. There are no capital gains.
3. Actual income taxes payable is \$45,000.

4. The amount of taxes actually available for refund through the carryback of the operating loss of \$100,000 equals \$18,000 since the company sustained a loss in the immediately preceding year which resulted in the refund of all but \$18,000 of taxes paid during the preceding three years.

Reply—Interpretation No. 11 to Accounting Principles Board Opinion No. 11, *Accounting for Income Taxes*, contains an illus-

tration of the presentation to be used in similar situations. A note to the illustration indicates that the refund should be computed at the amount actually refundable regardless of current tax rates. Therefore, the appropriate presentation would be as follows:

Loss before refundable income taxes.....	\$(100,000)
Refund of prior year's income taxes arising from carryback of operating loss.....	18,000
Loss before extraordinary items.....	<u>\$ (82,000)</u>
Extraordinary items, net of applicable tax effect:	
Description of items (\$200,000 less tax effect of \$63,000).....	137,000
Net income	<u><u>\$ 55,000</u></u>

.05 Realization of Tax Benefit of Loss Carryforward

Inquiry—What is the proper method of reporting the reduction in current income taxes resulting from the realization of the benefit of a carryforward of a prior year net operating loss?

Reply—Accounting Principles Board Opinion No. 11, paragraph 61 states, “When the tax benefit of an operating loss carryforward is realized in full or in part in a subsequent period, and has not been previously recognized in the loss period, the tax benefit should be reported as an extraordinary item in the results of operations of the period in which realized.”

Paragraph 61 of APB Opinion No. 11 is not modified or amended by APB Opinion No. 30.

.06 Tax Effect of Permanent Tax Differences in Business Combination

Inquiry—Company A acquired a subsidiary in a business combination which was treated as a purchase. As a result of assigning values to the acquired assets in accordance with Accounting Principles Board Opinion No. 16, a permanent tax difference arose.

Subsequent to the acquisition, a quasi-reorganization occurred. At the time of the quasi-reorganization, there were substantial loss carryforwards for both tax purposes and accounting purposes. In years after the quasi-reorganization, Company A's

operations included additional and unrelated timing differences involving the capitalization for accounting purposes of interest and taxes.

Financial statements for the present and recent periods show operating profits before income taxes. Such operating profits include amortization of the permanent difference described above to operations and also include timing differences described above. Should the tax effect of the permanent differences be charged to additional capital or to income?

Reply—Paragraph 49 of Accounting Principles Board Opinion No. 11 and Interpretation 16 to Opinion No. 11 indicate that the tax effect of the permanent difference should be charged to capital surplus rather than being charged to income.

.07 Tax Effect of Undistributed Earnings of Newly Acquired Subsidiary

Inquiry—Parent Company acquired a 100% interest in a subsidiary in a purchase transaction. The retained earnings of the subsidiary are also its accumulated earnings and profits as defined in the Internal Revenue Code and will be taxable as dividends upon distribution. There is no evidence, nor is it intended, that the subsidiary has invested or will invest the undistributed earnings indefinitely nor that the undistributed earnings will be remitted in a tax-free liquidation.

Should the potential tax effect of the subsidiary's undistributed earnings be recognized on the assumption that these earnings would be transferred to the Parent Company?

Reply—Since the parent could presumably decide on the alternative of a tax-free liquidation and transfer in this situation, the issue seems highly conjectural. However, if the retained earnings at acquisition are expected to be distributed as dividends, the tax effect should not be recorded at the time of acquisition, but charged to income when the dividend is paid to the parent company.

.08 Intercompany Tax Allocation for Consolidated Companies

Inquiry—A CPA, presently engaged in the examination of the financial statements of a group of corporations comprised of a parent holding company and three wholly owned subsidiaries, expects both separate financial statements of each company for

credit purposes, and consolidated financial statements will be prepared.

The subsidiaries will each have a net taxable income, but the parent expects to have a net taxable loss. A consolidated tax return is expected to be filed for all the corporations.

It will be necessary to disclose in a footnote on the statements of each subsidiary that a consolidated tax return is being filed and that tax expense has been allocated to each member of the group. What method of tax allocation should be used in such a situation?

Reply—This is primarily a legal, not an accounting question. When a group of companies has agreed to file a consolidated tax return, such companies must have agreed, explicitly or implicitly, on how such tax is to be paid. If there is no such agreement in writing, it would appear desirable that a written agreement be made between the respective boards of directors to guide the officers of the companies in making such allocation. The attorneys for the client should be consulted to determine how the liability is to be spread.

There are two different methods which have usually been used. In either case each company determines its income tax liability on a separate company basis. Under one method those companies which show positive taxes would share the total tax to be paid in the ratio of their separate-basis tax returns. In the other method, each subsidiary would be charged or credited by the parent with the tax or tax benefits to be shown in a separate return. The parent company would then enjoy the benefit or incur the loss resulting from a consolidated filing, on the theory that the consolidated return resulted from the parent's investment in the subsidiaries.

.09 Tax Allocation Among Subsidiaries of Public Utility Holding Company

Inquiry—Several subsidiaries of a holding company are regulated public utilities. For federal income tax purposes, the utilities file a consolidated tax return with other companies in the controlled group. For rate setting and their own accounting purposes, however, they compute their federal income taxes as if they were not members of a controlled group.

Which is the proper method of accounting for income taxes in this situation?

Reply—The allocation between subsidiaries of taxes payable on a consolidated federal income tax return is essentially a legal matter, because it affects the nature of the agreement between the companies when they agreed to file such a return.

In its regulation of public utility holding companies, the SEC requires the allocation of taxes computed on consolidated tax returns between companies on the basis of the tax that would be paid if separate tax returns had been filed; no provision is made for credits to companies with losses. This ruling is a function of the SEC's regulation of operations of public utility holding systems.

On the other hand, some accountants have recommended that each subsidiary in a tax consolidation credit the parent company for the amount of its income tax computed on a separate entity basis. Similarly, any subsidiary with tax losses should receive credit from the parent for the benefit of such losses. The difference between this net amount and the total tax represents the tax of the parent company. The underlying theory is that it is the parent's investment which permits a consolidated return to be filed.

The method to be followed should be determined by the companies involved, preferably by a formal agreement of the respective boards of directors.

.10 Shipbuilders' Capital Construction Reserve Funds

Inquiry—A company is the nonsubsidized owner and operator of ocean-going cargo vessels. Under the Merchant Marine Acts of 1936 and 1970, current income of such companies is exempt from income tax to the extent that it is deposited in a special fund for the future purchase of American flag vessels. The tax basis of the assets purchased from the special fund is zero, and therefore the tax advantage is reversed as depreciation for tax purposes will be less than book depreciation in future years.

The company is planning a substantial shipbuilding program. How should the deferred taxes arising from the deposits in the special fund be handled?

Reply—In APB Opinion No. 23, paragraph 2, the Board stated that it had decided to defer any conclusion as to whether interperiod tax allocation should be required in this special

area. This deferral of conclusion should relate only to the funds on deposit.

Therefore, even if the shipping company elects to defer to future years the tax effect equivalent to that portion of the profits which is deposited in the "Special Funds," deferred taxes should still be provided on funds not so deposited. When the timing difference reverses, if the tax effect is still being deferred as the result of deposits in the Special Fund, the effect of the reversal should be included in income. [Amended]

.11 Accounting for New Jobs Credit

Inquiry—How should the New Jobs Credit be accounted for?

Reply—The New Jobs Credit should be accounted for in a manner similar to the "flow-through method" of accounting for the investment tax credit.

.12 Effect of Loss Carryforwards on the Recognition of Investment Tax Credits

Inquiry—Corporation A has a net operating loss (NOL) carryforward sufficient to absorb the current year's income and thereby result in no income tax liability. The corporation also has accumulated sufficient investment tax credits during the current year to absorb its income tax liability. If the NOL carryforward is applied first, the income statement would reflect a provision for income taxes and an offsetting credit as an extraordinary item. If the current year's tax credits are applied first, the income statement would reflect a current income tax provision offset by the investment tax credit. Which presentation is more appropriate?

Reply—There is no clear authoritative literature on this particular subject. In accounting for investment tax credits when operating loss carryforwards are present, some accountants believe it is preferable that the investment tax credit not be recognized until it is actually realized. This is based on the sequence of utilization provided under the tax law, which would be to reflect the utilization of the operating loss carryforward prior to any utilization of investment tax credits. This approach would also provide disclosure for carryforward of NOLs and investment tax credits consistent with the tax return.

However, in practice, both approaches have been used.

.13 Amount of Operating Loss Carryforward Recognized

Inquiry—For the current year, Company A reported pretax accounting income of \$200,000 and taxable income of \$150,000. (1) What amount of a \$2,000,000 operating loss carryforward should be recognized as an extraordinary item? (2) Is there a deferred tax credit that should be reported for the \$50,000 timing difference?

Reply—(1) APB Opinion No. 11, *Accounting for Income Taxes*, paragraphs 45—48, provides guidance on accounting for operating loss carryforwards. As indicated in APB Opinion No. 11, paragraph 45, the tax benefits of operating loss carryforwards are usually not recognized until realized income is reported in the financial statements. Accordingly, assuming a 50% tax rate, Company A would show \$100,000 as an extraordinary item with an offsetting charge to income tax expense.

(2) No. APB Opinion No. 11, paragraph 36, states in part, “the tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income.” Since there is no income tax payable for accounting or tax purposes there would be no deferred tax credit to be reported in the financial statements, although an income tax provision would be reported as in (1) above.

The current year timing difference is now part of the different net operating loss carryforward for accounting and tax purposes, i. e., \$1,800,000 and \$1,850,000, respectively. When the operating loss for tax purposes is realized it would create a tax benefit that should effect the deferred tax credit account.

➡ *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. _____

➤➤➤→ *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.

➤➤➤→ *The next page is 4601.* ←➤➤➤

Section 5300

Prior Period Adjustments

.01 Correction of Error

Inquiry—Corporation A received an insurance refund of \$45,000 in January 19X2. After a limited investigation as to why the money was received, Corporation A concluded the refund was an adjustment of premiums previously paid. The \$45,000 was reflected in the January 31, 19X2 financial statements as a reduction of expense. Subsequently, Corporation A was notified that the amount had been refunded in error. How should the \$45,000 be reported in the January 31, 19X3, financial statements?

Reply—The \$45,000 should be reflected in the January 31, 19X3 financial statements as a prior period adjustment because it involves a correction of error in previously issued financial statements, even though the error was not necessarily made by the client.

➤ *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.

.03 Gain on Involuntary Conversion

Inquiry—Corporation A realized a material gain when its facilities located in a designated floodway were acquired by Urban Renewal. How should the gain be reported?

Reply—The act of Urban Renewal acquiring the property may be viewed as a form of expropriation under paragraph 23 of Accounting Principles Board Opinion No. 30. Paragraph 23 indicates that a gain or loss from sale or abandonment of property, plant, or equipment used in the business should be included as an extraordinary item if it is the direct result of an expropriation. Accordingly, the gain should be reported as an extraordinary item and presented in the income statement in accordance with paragraphs 10-12 of the Opinion.

If gain is not reported for tax purposes in the current period because all the proceeds received from Urban Renewal were reinvested in new facilities, deferred taxes should be accounted for in accordance with APB Opinion No. 11, *Accounting for Income Taxes*.

.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.” While it is true that death of a specific individual is an infrequent occurrence, death 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.”

➡ The next page is 4851. ⬅

Section 5500

Earnings Per Share

.01 Earnings Per Share on Combined Financial Statements

Inquiry—Combined financial statements are prepared for a large group of family owned corporations. How should earnings per share be shown on these financial statements?

Because of the great differences in values between the shares of the twenty corporations, it would seem inappropriate to attempt to arrive at some kind of total earnings per share. Furthermore, it could be very misleading to imply that a share of ownership in one corporation entitled a particular family member to a share of the combined companies.

Reply—Earnings per share may be presented when combined financial statements include only two entities and reasonable assumptions can be made about the shares to be used in the computations.

However, presentation of earnings per share would not be appropriate in this situation because of the large number of corporations and stock issues involved.

.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 Accounting Principles Board Opinion No. 15 concerning earnings per share states in part:

This Opinion also does not apply to parent company statements accompanied by consolidated financial statements, to statements of wholly-owned subsidiaries, or to special purpose statements.

Therefore, it is not necessary to show earnings per share figures for the subsidiaries.

.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—Interpretations No. 64 (*Total of Quarters May Not Equal Annual EPS*) and No. 80 (*Debt Eligible Only While Outstanding*) to Accounting Principles Board Opinion No. 15 lead to the conclusion that computations on an interim basis are independent, and that interim earnings per share need not necessarily equal the amount computed for the year. Therefore, 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.

.04 Earnings Per Share for Two Classes of Common Stock

Inquiry—A corporation has two classes of stock outstanding. Class A stock has certain provisions attached to it that allow Class A stockholders a larger share of any dividends than Class B stockholders. Upon dissolution of the corporation, however, holders of Class A stock may receive only the par value of the stock plus 6% of the retained earnings.

How should earnings per share be determined for the Class A stock?

Reply—In the event of dissolution, Class A stockholders will receive the par value of their stock plus 6% of the retained earnings; therefore, the portion of each year's net income allocable to the Class A stock should be the amount of cash or stock dividends credited to such stock, plus (or minus) 6% of net income (or deficit) for the year after deducting cash and stock dividends on both classes of stock.

The earnings per share for the Class B stock would be based upon earnings remaining after the portion assigned to the Class A stock.

This assumes that dividends payable to the Class B stockholders would be limited to the percent payable on Class A stock, either by written agreement or by unwritten understanding. If however, there is no such limitation on dividends payable for Class B stock, in determining the earnings per share of such Class B stock, the earnings attributable to the Class A stock should be limited to cash and stock dividends credited to it.

.05 Earnings Per Share with Contingently Convertible Class B Stock

Inquiry—A corporation has two classes of common stock. Class B stock is "founders' stock" and is convertible at any time into Class A stock on the basis of one share of A for each five

shares of B. However, in the event that the company attains a certain earnings level, the Class B can be converted to Class A on a one-for-one ratio. There is a limit on the number of shares of B that can be converted one-for-one each year, and it would take nearly seven years of operations at the required earnings level for all the shares of B to be converted on this basis. Furthermore, the earnings level required for the favorable conversion will increase from year to year based on the number of shares of B that have previously been converted.

How should these two classes of stock be considered in determining the earnings per share?

Reply—In determining the effect on earnings per share of contingently convertible Class B stock, it is necessary to assume that the current level of earnings will continue. Therefore in determining the number of shares to be converted on a one-for-one basis, assume conversion in each year until the effect of the converted shares would increase the required earnings to a point where no more shares would be converted at the current level. In this way, computations of earnings per share resulting from contingent issuance of shares is based not upon any prediction of the future results, but on an arbitrary assumption that present earnings levels are continued. See paragraphs 62 and 64 of Accounting Principles Board Opinion No. 15, and Accounting Interpretation 91 to APB Opinion 15.

In computing fully diluted earnings per share, increased earnings should be assumed sufficient so that all Class B shares would be converted. If the earnings per share figure, based on the additional income required divided by the additional number of shares then outstanding, would be dilutive, that figure should be reported as fully diluted earnings per share.

.06 Earnings Per Share with Cumulative Preferred Stock

Inquiry—A corporation has 24,000 shares of \$10 par value common stock and 25,000 shares of \$10 par value preferred stock outstanding.

The preferred stock was issued in 1972 for full value, with 6% preferred dividends, cumulative; preference in distribution for face value plus unpaid dividends; and conversion privilege after fifth year at the rate of 10 preferred shares for 7 common shares, plus one common for each \$10 of unpaid preferred dividends. For

the fiscal year ended in 1974 the net income after income taxes but before preferred dividends was \$39,000; for the prior year, \$17,000. No dividends have been paid on the preferred stock and the two years' dividends amount to \$30,000. The stocks are closely held and have no determinable market value.

How should earnings per share be calculated under these circumstances?

Reply—Assuming the preferred stock should not be considered a common stock equivalent, and there are no options, warrants, or other potentially dilutive securities outstanding, earnings per share would be calculated as follows:

	<u>1974</u>	<u>1973</u>
Primary Earnings Per Share:		
Number of common shares	24,000 sh.	24,000 sh.
Net income	<u>\$39,000</u>	<u>\$17,000</u>
Preferred dividends earned	<u>15,000</u>	<u>15,000</u>
Income applicable to common shares	<u>\$24,000</u>	<u>\$ 2,000</u>
Income per common share	<u><u>\$1.00</u></u>	<u><u>\$.08</u></u>
Fully Diluted Earnings Per Share:		
Number of fully diluted shares:		
Common shares	24,000 sh.	24,000 sh.
Conversion of preferred excluding dividend factor . .	17,500	17,500
Additional shares for unpaid dividends	3,000	1,500
Total	<u><u>44,500 sh.</u></u>	<u><u>43,000 sh.</u></u>
Income (before preferred dividends)	<u>\$39,000</u>	<u>\$17,000</u>
Income per common share— assuming full dilution	<u><u>\$.88</u></u>	<u><u>\$.40*</u></u>

* As this is greater than the primary per-share figure, it is anti-dilutive and therefore should be disregarded.

Therefore, the amounts to be reported are:

Income per common share	<u>\$1.00</u>	<u>\$.08</u>
Income per common share— assuming full dilution	<u><u>\$.88</u></u>	<u><u>\$.08</u></u>

.07 Earnings Per Share with Noncumulative Preferred Stock

Inquiry—A corporation has two types of stock outstanding: no par common stock and \$100 par, 7% noncumulative preferred stock. How should earnings per share be shown if no dividends have been declared?

Reply—Paragraph 50 of Accounting Principles Board Opinion No. 15 states in part:

If interest or preferred dividends are not cumulative, only the interest accruable or dividends declared should be deducted. In all cases, the effect that has been given to rights of senior securities in arriving at the earnings per share should be disclosed.

This matter is also discussed in Accounting Interpretation No. 21 to APB Opinion 15.

Therefore, if no dividends have been declared on the noncumulative preferred stock, the earnings per share should be computed as if no such preferred stock were outstanding. There should be disclosure that no provision has been made for dividends on the preferred stock because the stock is not cumulative and no dividends have been declared.

.08 Callable Debentures in Determining Shares Outstanding

Inquiry—A client issued convertible debentures several years ago. The call date for these debentures is now only a few weeks away, and the client fully intends to call all of the securities on this date.

How should this debt be considered in calculating earnings per share on the financial statements dated two weeks after the call date? Although the debentures may technically be convertible, for practical purposes they are nonconvertible. Should the debt, therefore, not be considered in determining earnings per share?

Reply—The convertible debentures would be included in the earnings per share computations according to Accounting Principles Board Opinion No. 15 until the time they are called. Refer to APB Opinion No. 15, Interpretation No. 25 entitled *Weighted Average of Shares Outstanding*. As indicated there, a weighted average gives due consideration to all shares outstanding and assumed to have been outstanding during a period. Assuming the shares are called on the call date, the earnings per share computations should give consideration to the convertible debentures

up to that time. It does not mean that the convertible debentures should be ignored in computing earnings per share.

.09 Conversion Price of Debentures for Computing Fully Diluted Earnings Per Share

Inquiry—A company has issued debentures which are convertible into shares of the company from date of issuance through January 1, 1980 at \$50 per share (substantially below current market price and market price at date of issuance). The new conversion price, to be established on January 1, 1980, will be fixed through maturity of the debentures in 1990. Management estimates that the conversion price established on January 1, 1980 will approximate the current conversion price.

What conversion price should be used in computing fully diluted earnings per share from the date of issuance of the debentures to January 1, 1980?

Reply—The section on convertible securities in Part 1 of the Introduction to AICPA Accounting Interpretations of APB Opinion No. 15 indicates:

Convertible securities which require the payment of cash at conversion are considered the equivalent of warrants for computational purposes. Both the treasury stock method and the if converted method must be applied.

Paragraphs 36-38 of Accounting Principles Board Opinion No. 15 discuss the treasury stock method and paragraphs 51-53 provide computational guidelines for the "if converted method." Paragraph 58 deals with the conversion rate or exercise price to be used in computing fully diluted earnings per share, and states:

Fully diluted earnings per share computations should be based on the most advantageous (from the standpoint of the security holder) conversion or exercise rights that become effective within ten years following the closing date of the period being reported upon.

The conversion price to be used in connection with the "if converted method" should be \$50 per share. Management estimates that the projected market price as of January 1, 1980 would be such that the new conversion price would approximate the \$50 per share fixed conversion price from the date of issuance to January 1, 1980. Therefore, the \$50 is effectively the most advantageous exercise price and should be used under the "if converted method."

.10 Convertible Debentures Held by Federal Government

Inquiry—A wholly-owned subsidiary purchased a utility from the federal government. As part of the consideration in this purchase, debentures with an interest rate of 2% were issued to a department of the federal government. These debentures are payable in ten years or convertible at that time to 20% of the common stock of the subsidiary.

Should these debentures be considered as common stock equivalents in the determination of earnings per share on the consolidated financial statements?

Reply—Paragraph 65 of Accounting Principles Board Opinion No. 15 says in part:

At times subsidiaries issue securities which should be considered common stock equivalents from the standpoint of consolidated and parent company financial statements for the purpose of computing earnings per share. This could occur when convertible securities, options, warrants or common stock issued by the subsidiary are in the hands of the public and the subsidiary's results of operations are either consolidated or reflected on the equity method.

It appears that the key consideration in this problem is whether the debentures are deemed to be "in the hands of the public" as discussed in paragraph 65. Since the United States Government does not make it a general practice to acquire common stock investments in commercial enterprises, the debentures held by the United States should not be considered as common stock equivalents. The client may wish to include disclosure of why these debentures are treated in the manner suggested since a 2% interest rate would normally require that the debentures be considered common stock equivalents.

.11 Warrants Outstanding for Less Than Three Months

Inquiry—Under paragraph 36 of Accounting Principles Board Opinion No. 15, it is recommended that any assumption that outstanding warrants will be exercised should not be reflected in earnings per share until the market price of the common stock has been in excess of the warrants' exercise price for substantially all of three consecutive months ending with the last month of the period.

A company issued warrants one month prior to the end of its fiscal year. Should the earnings per share figure reflect these outstanding warrants? If so, should the prior three-month period or

only the last month be considered in determining the market price?

Reply—As the warrants have been outstanding only one month prior to the end of the fiscal year, it is not required that the earnings per share reflect the stock represented by the warrants.

.12 Five Year Options as Common Stock Equivalents

Inquiry—A company instituted a stock option plan under which 25% of the options are exercisable each year commencing in one year. In computing earnings per share, how should these installment options be considered?

Reply—Since all the options are exercisable within five years of the balance sheet date, paragraph 36 of Accounting Principles Board Opinion No. 15 requires that the options involved be considered common stock equivalents, and included in earnings per common share and common share equivalent whenever the market price exceeds the exercise price.

If the common stock equivalent had not been exercisable or convertible within five years of the balance sheet date, paragraph 57 of APB 15 would require that the options not be considered in computing earnings per share.

.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 agree-

ment, and based upon the fact that legal counsel has advised 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.

The question of what happens should the “optionees” default under the subscription agreement should not alter the fact that at the present time the 50,000 shares are issued and the purchaser has the right to vote the shares and to receive any dividends. If the purchaser defaults, the disposition of the common stock and paid-in capital and any collections made to date would depend upon applicable state law and legal counsel would have to be consulted.

.14 Net Loss Per Share With Subsequent Granting of Stock Options

Inquiry—A client, a closely held corporation, suffered a net loss for the period just ended. Nonconvertible debt of the corporation was held by its parent corporation at the balance sheet date.

Subsequent to the balance sheet date, the liability was converted to common stock. A large number of additional shares were also issued for cash, and options to purchase additional shares were granted but not exercised.

At the balance sheet date, the parent company owned 90% of the clients' stock. After the above transactions, the parent owns 66% of the stock, and if all the options are exercised, no stockholder will own more than 50% of the corporation.

How should earnings per share be calculated in this situation, and what supplementary information is necessary in the financial statements of the client?

Reply—Computations of earnings per share data for a situation such as this is covered by paragraphs 22 and 23, paragraph 38, and paragraph 40 of Accounting Principles Board Opinion No. 15, *Earnings per Share*. Basically, the primary earnings per share should be related to the capital structure existing during each of the various periods presented. Therefore, the primary loss per share would be based on the shares of stock outstanding at the balance sheet date. The purpose of fully diluted earnings per share data is to show the maximum potential dilution of current earnings per share on a prospective basis. Therefore, the supplementary earnings per share would normally re-

flect the conversion of the liability, the additional shares sold for cash, and the shares applicable to the options. However, paragraph 40 of Opinion No. 15 indicates that computations of fully diluted earnings per share data for each period should exclude those securities whose conversion, exercise, or other contingent issuance would have the effect of increasing the earnings per share amount or decreasing the loss per share amount. Therefore, for this situation, there should be footnote disclosure of the subsequent transactions relating to the capital structure of the company but the loss per share should not be adjusted to reflect these items since to do so would reduce the loss per share. This would be anti-dilutive under paragraph 40 of the Opinion.

.15 Stock Dividend Declared But Not Paid at Balance Sheet Date

Inquiry—A client declared a 5% stock dividend to shareholders of record in December, 1974, payable in 1975. In calculating the weighted average number of shares outstanding for determining the earnings per share for 1974, how should this stock dividend apply?

Reply—Paragraph 48 of Accounting Principles Board Opinion No. 15 states:

Stock dividends or splits. If the number of common shares outstanding increases as a result of a stock dividend or stock split or decreases as a result of a reverse split, the computations should give retroactive recognition to an appropriate equivalent change in capital structure for all periods presented. If changes in common stock resulting from stock dividends or stock splits or reverse splits have been consummated after the close of the period but before completion of the financial report, the per share computations should be based on the new number of shares because the readers' primary interest is presumed to be related to the current capitalization. When per share computations reflect such changes in the number of shares after the close of the period, this fact should be disclosed.

Therefore, the 5% stock dividend should be considered as being outstanding for each month of 1974, as well as for each month of each preceding period presented.

.16 Indeterminate Value of Stock of Closely Held Company

Inquiry—A closely held company has only one class of stock with 100 shares authorized, 45 shares issued, and 55 shares held in the treasury. An option to purchase 15 shares of stock is outstanding at \$4,800 per share. Must a closely held corporation report earnings per share? If so, would the following computa-

tion of "primary earnings per share of common stock" be acceptable (assuming market value exceeds the option price and the \$72,000 proceeds from the sale of the 15 shares of stock is applied against debt)?

Adjustment of net income:

Actual net income	\$51,600
Interest reduction less 50% tax effect	<u>2,400 *</u>
Adjusted	<u><u>\$54,000</u></u>

Adjustment of shares outstanding:

Actual outstanding.....	45
Net additional shares issuable by option	<u>15</u>
Adjusted shares outstanding	<u><u>60</u></u>

Primary earnings per share of common stock—adjusted net income divided by adjusted shares outstanding.....	<u><u>\$900</u></u>
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* Computation of interest reduction:

	<u>Interest</u>
Short-term debt (total).....\$40,000 @ 8%	\$3,200
Long-term debt (portion)..... 32,000 @ 5%	<u>1,600</u>
Total	<u><u>4,800</u></u>
Less 50% tax effect.....	<u>2,400</u>
Interest reduction less 50% tax effect.....	<u><u>\$2,400</u></u>

Reply—As stated in Interpretation No. 10 to Accounting Principles Board Opinion No. 15, closely held corporations are required to report earnings per share. The first nine of the fifteen option shares should be applied on the treasury stock method and the remaining six to retire debt, as described in paragraph 38 of APB Opinion No. 15. However, if market value is indeterminable, but the assumption that proceeds from exercise of option be used to retire debt would produce similar results, use of the calculations outlined in the inquiry would appear as a means of obtaining an objectively determinable figure. In presenting the statements, there should be a footnote disclosing that in cal-

culating earnings per share it was not considered feasible to use the treasury stock method, since market value of the stock could not be objectively determined and that instead it was assumed that proceeds from exercise of the option would have been used to reduce debt.

➤ *The next page is 4891.* ←

Section 5600

Leases

.01 Fee Received by Lessor for Assignment of Lease

Inquiry—A lessor assigns its lease agreements (sales type or direct financing) to financing institutions and they collect the monthly lease payments directly from the lessees. The lessor and financing institution are not related. The lessor receives at date of assignment a fee representing the difference between the equipment cost and the present value of the total gross lease payments plus the amount of two lease payments. Should the lessor recognize the fee as income at the time a lease agreement is assigned or should the fee be accounted for as unearned income?

Reply—FASB Statement No. 13, *Accounting for Leases*, paragraph 20, states:

The sale or assignment of a lease or of property subject to a lease that was accounted for as a sales-type lease or direct financing lease shall not negate the original accounting treatment accorded the lease. Any profit or loss on the sale or assignment shall be recognized at the time of the transaction except that (a) if the sale or assignment is between related parties, the provisions of paragraphs 29 and 30 shall be applied, or (b) if the sale or assignment is with recourse, it shall be accounted for in accordance with FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*.

If an assignment is without recourse, the lessor should recognize the fee as income at the time of the assignment because the lease is not assigned to a related party. [Amended]

.02 Lease Between Related Parties

Inquiry—Company A leases a facility that is owned by the spouse of the majority stockholder of Company A. The lease does not transfer ownership to the lessee or contain a bargain purchase option. Lease payments were determined by an independent real estate broker. Would this lease be a capital or operating lease?

Reply—The determination of whether the lease between Company A and the spouse of the Company's majority stock-

holder is a capital or operating lease does not rest on the fact that it is between related parties but on whether one of the criteria in FASB Statement No. 13, *Accounting for Leases*, paragraph 7, is met.

.03 Accounting for "Free Rent" and Scheduled Rent Increases Under an Operating Lease

Inquiry—As an inducement to enter a lease, Company A (Lessor) grants Company B (Lessee) six months of "free rent" under an operating lease. The lease also provides for scheduled rent increases of \$100 per month effective in the second year and each year thereafter for five years. Should Company B begin recording rental expense in the seventh month of the lease and should it only record the monthly rent paid as stipulated in the lease?

Reply—No. FASB Statement No. 13, *Accounting for Leases*, paragraph 15, states, "if rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis. . . ." FASB Technical Bulletin 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*, reaffirms and provides further guidance on this issue.

Therefore, Company B will record rental expense over the entire term of the lease including the first six months. Total payments to be made under an operating lease should be charged to expense evenly over the lease term including the period of "free rent". The difference between the amount charged and the amount paid would be an increase or decrease to accrued rent payable.

TIS Section 6000

SPECIALIZED INDUSTRY PROBLEMS

TABLE OF CONTENTS

Section

6100 Banks

- .01 Date for Reporting on Balance Sheet Only [Amended]
- [.02] Reserved
- [.03] Reserved
- .04 Allocation of Minimum Tax on Excess Allowable Additions to Provision for Loan Losses
- .05 Real Estate Carried at Nominal Value
- .06 Gain on Sale of Old Coins
- .07 Stock Dividends Capitalized at Par Value [Amended]
- .08 Adequacy of Allowances for Bank Loan Losses
- .09 Disclosure of Examination Reports by Regulatory Authorities to Independent Auditors
- .10 Bank Loan Disclosures
- .11 Accounting for Bank Deposit Float
- .12 Accounting for Foreign Loan Swaps

6110 Savings and Loan Associations

- [.01] Reserved
- .02 Mutual Banks and Associations—Business Combination
- .03 Mutual Banks and Associations—Valuation of Assets and Liabilities Acquired in a Purchase [Amended]
- .04 Mutual Banks and Associations—Determination of Acquiring and Acquired Company
- .05 Accounting for Loan Servicing Fees When Mortgage Loans Are Sold and Seller Retains Servicing Rights
- .06 Determination of Net Realizable Value of Certain Real Estate Transactions
- [.07] Reserved
- .08 Accounting for Loan Origination Fee Income Under a Federal Home Bank Board Rule
- .09 Preferred Stock of Federal Home Loan Mortgage Corporation Received as a Dividend
- .10 Certain Real Estate Arrangements of Financial Institutions

6120 Credit Unions

- .01 Modified Cash Basis Financial Statements [Amended]
- .02 Applicability of FASB Statement No. 12, *Accounting for Certain Marketable Securities* [Amended]

6130 Finance Companies

- .01 Amortization of Discount on Receivables of Consumer Finance Companies

Section**6130 Finance Companies—Continued**

- .02 Method of Recognizing Revenue from Finance Charges
- .03 Method of Recognizing Revenue from Service Charges
- .04 Method of Recognizing Revenue from Commissions on Loan Insurance
- .05 Disclosure of Contractual Maturities of Direct Cash Loans
- .06 Balance Sheet Presentation of Subordinated Debt [Amended]
- .07 Accounting for Non-refundable Discounts on Long-Term Loans

6200 Regulated Industries

- .01 Deferral of Purchased Power Expense by Public Utilities [Amended]
- .02 Recognizing Revenues by Public Utilities Using Cycle Billing
- .03 Financial Statement Presentation of Power Service Rights by Electric Cooperative [Amended]

6300 Insurance Companies

- .01 Recognition of Commission Income by Insurance Agency [Amended]
- .02 Method of Recognizing Revenue from Commissions on Credit Life Insurance
- .03 Recognition of Income on Unclaimed Refunds Due Policyholders on Policy Cancellations
- .04 Reserve for Future Claims of Title Insurance Company
- [.05] Reserved
- .06 Accounting and Disclosure for Reinsurance Transactions
- .07 Liability for Unasserted Claims

6400 Hospitals

- .01 Combined or Separate Financial Statements for Individual Funds
- .02 Combined Financial Statements of Related Tax-Exempt Corporations
- .03 Designation of Income from Endowment Fund
- .04 Hospital as Collecting Agent for Physicians
- [.05] Reserved
- .06 Presentation of Medicare Financing Payments
- .07 Accounting for Reimbursement from Medicare in Excess of Standard Rates
- .08 Qualification of Auditor's Opinion for Uncertainty in the Amount of Medicare Reimbursements
- .09 Financial Statement Presentation of Claims for Reimbursement Subject to Adjustment
- .10 Applicability of *AICPA Hospital Audit Guide* to a City-Owned Hospital
- .11 Funds Received from State for Medical School
- .12 General Obligation Bonds Issued for Current Use by City-Owned Hospital

Section**6410 Nursing Homes**

- [.01] Reserved
- .02 Deferral of Reimbursement Income Due to Difference in Depreciation Methods
- .03 Accounting for Home Office Management Team Costs and Revenues

6500 Extractive Industries

- [.01] Reserved
- [.02] Reserved
- .03 Disclosure of Contingent Liability for Royalties

6600 Real Estate

- .01 Method of Recognizing Revenue from Commissions by Real Estate Brokerage Firm
- .02 Method of Recognizing Revenue from Sales of Condominiums
- .03 Accounting for Sale of Property with Option to Repurchase
- .04 Method of Recognizing Profit on Sale of Undeveloped Land with a Release Provision
- [.05] Reserved
- [.06] Reserved
- .07 Accounting for Nonmonetary Exchange of Land
- .08 Work Performed by Purchaser

6610 Retail Land Sales Companies

- .01 Financial Statement Presentation of Real Estate Developer [Amended]
- .02 Accounting for the Cost to Reacquire Land Sales Contracts by the Seller [Amended]
- .03 Disclosure of Appraisal Value of Land Held for Resale or Development [Amended]
- .04 Allocation of Land Costs to Parcels Sold [Amended]

6700 Construction Contractors

- .01 Distinction Between Long-Term and Short-Term Construction Contracts [Amended]
- [.02] Reserved
- [.03] Reserved
- [.04] Reserved
- .05 Classification of Profit on Uncompleted Negotiated Contracts
- .06 Effect of Retainages on Percentage of Completion Method
- [.07] Reserved
- [.08] Reserved
- [.09] Reserved
- .10 Payments for Landfill Rights

6900 Other Specialized Industries

Section**6910 Investment Companies**

- .01 Valuation of Securities at Cost or Fair Value
- [.02] Reserved
- .03 Basis of Valuation of Investments in Rental Property

6920 Voluntary Health and Welfare Organizations

- [.01] Reserved
- [.02] Reserved
- .03 Basis of Valuation of Donated Materials
- .04 Confirmation of Pledges Receivable Necessary Audit Procedure
- [.05] Reserved
- [.06] Reserved
- .07 Allocation of Fund Raising Expenses
- .08 Depreciation Accounting Adopted
- .09 Valuation of Real Estate Investments

6930 Employee Health and Welfare Benefit Plans

- .01 Computation of Liability for Accumulated Eligibility Credits
- .02 Disclosure of Maintenance of Benefits Provision
[Amended]
- .03 Financial Statement Presentation of Underwriting Loss
[Amended]

6935 Profit Sharing and Pension Plans

- .01 Financial Statements for a Profit Sharing Plan
- .02 Depreciation of a Real Estate Investment Owned by a Defined Benefit Pension Plan

6940 Franchisors

- .01 Method of Accounting for Sale of Territorial Franchise Right [Amended]

6950 State and Local Governmental Units

- .01 Financial Statements of Indian Tribe as a Governmental Entity
- .02 Balance Sheet Presentation of Outside Interest in Water Facilities
- .03 Effect on Auditor's Opinion of Inconsistency in Charging Operating Costs to Funds of School Districts
[Amended]
- [.04] Reserved
- .05 Confirmation of Taxing District's Taxes Receivable
[Amended]
- [.06] Reserved
- .07 Transfers Between Funds [Amended]
- .08 Litigation Settlement Received in Installments [Amended]
- .09 Inadequate Property Records [Amended]

Section

6950	State and Local Governmental Units—Continued
	.10 School Cafeteria System Not Accounted for as Enterprise Fund [Amended]
	.11 Combined Financial Statements for Homogeneous Operations
	.12 Depreciation and Contributions in Aid to Construction [Amended]
	[.13] Reserved
6955	Single Audit Act of 1984
	.01 Entities Subject to the Act
	.02 Scope of Audit
	.03 Internal Control
	.04 Audit Reports
	.05 Frequency of Audits
	.06 Generally Accepted Government Auditing Standards
	.07 Generally Accepted Auditing Standards
6960	Colleges and Universities
	.01 Auditors' Reporting Obligations in Connection with Departures from Industry Audit Guides
	.02 Valuation of Fixed Assets when Historical Records are Unavailable
	.03 Mandatory Transfer of Interest on College's Construction Loans
	.04 Direct and Indirect Costs to be Included in Educational and General Expenses and Auxiliary Enterprises
	.05 Accounting for Pledges Receivable as Assets
	.06 Expenditures for Library Books
	.07 Changes in Assumptions Related to Annuity Funds
	[.08] Reserved
	.09 Revenue and Expenditures for Summer Session
	[.10] Reserved
	.11 Accounting for Compensated Absences
	.12 Allocation of Overhead
6970	Entertainment Industry
	[.01] Reserved
6980	Brokers and Dealers
	.01 Auditor's Report on Internal Accounting Control for Broker-Dealers

➡➡➡ *The next page is 5171.* ⬅⬅⬅

Section 6100

Banks

.01 Date for Reporting on Balance Sheet Only

Inquiry—An auditor, in the process of performing a director's examination for a local bank, will express an opinion on the balance sheet only and will report on the cash count, pursuant to SAS No. 29, that he made on August 22. Should this date be used in reporting on the bank's financial condition?

Reply—If the auditor renders a report on the statement of financial condition as of July 31 or August 31, it will be necessary to 1) undertake additional auditing procedures as of the dates selected, 2) conduct a review of internal control, and 3) test the intervening transactions. Therefore, it would appear more practical to render a report on the August 22 statement of financial condition. [Amended]

.04 Allocation of Minimum Tax on Excess Allowable Additions to Provision for Loan Losses

Inquiry—Banks (and other financial institutions) are required to pay a minimum tax on the excess of the allowable addition to the reserve for bad debts over the reasonable addition to the reserve that would have been allowable if the reserve had been maintained on the basis of actual loss experience (Internal Revenue Code Sec. 57(a)(7)).

Is this minimum tax on tax preference items an income tax subject to the tax deferral accounting provision of Accounting Principles Board Opinion No. 11?

Reply—APB Opinion No. 11, paragraph 13a, defines income taxes as, "Taxes based on income determined under provisions of the United States Internal Revenue Code and foreign, state and other taxes (including franchise taxes) based on income." AICPA Industry Audit Guide, *Audits of Banks* (1983), page 94, indicates that tax allocation in connection with loan loss reserves should be followed. This would indicate that the Committee on Bank Accounting and Auditing considered the minimum tax on tax preference items an income tax under APB Opinion No. 11. In Report No. 91-552 on the Tax Reform Act of 1969 entitled "Report of the Committee on Finance—United

States Senate," page 111 indicates under the heading "Minimum Taxes and Allocation of Deductions," "Under present law, many individuals and corporations do not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-exempt income or special deductions." In another government publication entitled "Tax Reform Studies and Proposals—U.S. Treasury Department—Joint Publication—Committee on Ways and Means of the U.S. House of Representatives and Committee on Finance of the U.S. Senate" dated February 5, 1969 (part 2), page 136, in discussing the Minimum Tax Base, indicates, "The proposed minimum tax system would build upon the income concepts applicable under the regular income tax." The latter two quotations, coupled with the accounting for loan loss reserves indicated by the Committee on Bank Accounting and Auditing, lead to the conclusion that the minimum tax on tax preference items (especially as it relates to the reserves for losses on bad debts of financial institutions) is an income tax as defined in APB Opinion No. 11.

.05 Real Estate Carried at Nominal Value

Inquiry—A bank has a main office in a prime downtown location. The bank owns the real estate and carries it on the books at \$1. The undepreciated cost of the land and buildings under normal straight line methods and rates would approximate \$300,000. Should the bank's statement of financial condition show the real estate at the original cost less depreciation with an appropriate addition to undivided profits?

Reply—In the past, banks frequently wrote off, wrote down, or rapidly amortized buildings and equipment without regard for useful life. This practice was generally accepted within the banking industry and stemmed from the desire to remove items from the statement of condition which could not readily be converted into cash. Regulatory authorities also encouraged the practice. This practice, although "conservative" from a balance sheet point of view, does not produce fairly presented financial statements. The balance sheet is obviously understated both in the assets and capital sections, and the earnings statements become overstated for a number of years because normal depreciation will not be shown as an operating expense. Fortunately, the practice has been dying out, and most banks now follow practices conforming with normal practices of other industries. Accordingly,

the original cost of the land and buildings still in use and the applicable depreciation allowance account should be reinstated, with an appropriate credit to undivided profits. The reinstatement of assets acquired since December 31, 1959, is required by regulations of the Board of Governors of the Federal Reserve System and the FDIC.

.06 Gain on Sale of Old Coins

Inquiry—Prior to the issuance of silver coins with reduced silver content, a bank acquired a large quantity of old coins with high silver content. These coins were counted as part of the vault cash at face value and were considered part of the reserves of the bank. The coins were later sold at a premium. Is the gain on the sale an extraordinary item?

Reply—Since the sale of coins may be considered an ordinary and typical activity of a bank, considering the environment in which the bank operates, the transaction does not meet the criterion for an extraordinary item under paragraph 20(a) of Accounting Principles Board Opinion No. 30. The transaction should be treated in accordance with paragraph 26 of APB

➤ *The next page is 5175.* ←

Opinion No. 30, which states that “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.”

.07 Stock Dividends Capitalized at Par Value

Inquiry—May a bank capitalize a 10% stock dividend at par value?

Reply—AICPA Industry Audit Guide, *Audits of Banks*, pages 88-89, indicates that while it has been a traditional practice for banks to capitalize stock dividends at par value, there is no regulatory prohibition against capitalizing at fair value. Accordingly, stock dividends should be capitalized using fair value. If a stock dividend is recorded at an amount other than fair value, the difference between the recorded amount and fair value should be disclosed. [Amended]

.08 Adequacy of Allowances for Bank Loan Losses

Inquiry—How do general economic conditions, economic conditions in certain industries and regions, and the number of banks on the “troubled” lists of supervisory agencies, affect the CPA’s evaluation of the adequacy of a bank’s allowance for loan losses?

Reply—When such conditions are unfavorable, CPAs auditing bank financial statements may need to give additional attention to the allowance for loan losses, insider loans and loan participations purchased and sold.

As discussed in the AICPA Industry Audit Guide, *Audits of Banks*, the objective in auditing a bank’s allowance is to evaluate its reasonableness. All relevant conditions existing at the balance sheet date should be considered in evaluating the reasonableness of the allowance; accordingly, mechanical formulas should not be overemphasized. Factors which may cause loans to develop credit risk problems include improper credit extension procedures, changes in the economy, changes in the status of a particular industry or geographic area, undue loan concentrations, insider transactions and deterioration in the credit worthiness of the borrower.

With respect to insider loans, the CPA should find helpful the guidance provided in the Audit Guide and SAS No. 45, *Omnibus Statement on Auditing Standards—1983*. The existence of affiliated banks and affiliated organizations that are not audited by the CPA may require additional audit attention by the CPA in his examination.

With respect to loans or participations in loans purchased from other banks, the CPA should be mindful that audit procedures should be similar to those for direct loans, except that requests for confirmation of balances and collateral, if any, are normally sent to the originating bank. These procedures include evaluation of collectibility and inspection of supporting documentation. Since delinquent payments are generally an important indicator of deterioration in credit quality, CPAs should consider determining the actual status of borrower payments such as through confirmation with the originating bank. In auditing banks which have sold participations, the CPA should be alert to matters such as payments of principal and/or interest to the purchasing bank in advance of actual receipt from

the borrower and inadequate loan documentation. Such matters might indicate ineffective credit granting and administration procedures and a commitment of the originating bank to repurchase such loans or to share in any losses.

Chapters 7 and 8 of the Audit Guide should be helpful to CPAs in auditing the allowance for loan losses, insider loans and loan participations.

(The above is consistent with an item in "The CPA Letter" dated December 12, 1983.)

.09 Disclosure of Examination Reports by Regulatory Authorities to Independent Auditors

Inquiry—An auditor who is in the process of performing an examination of the financial statements of a bank may be aware that a regulatory agency such as the Federal Deposit Insurance Corporation (FDIC) has performed an examination. Would it be appropriate for the auditor, as part of his auditing procedures, to request and receive a copy of the report of the bank examiner?

Reply—Yes. Disclosure of reports of examination by regulatory authorities to independent auditors and others was the subject of meetings late in 1983 between representatives of the AICPA banking committee and the staffs of the FDIC and the Office of the Comptroller of the Currency (OCC).

The FDIC advised the AICPA that Regional Directors have been informed by Washington that "accountants and attorneys hired by a bank and acting in their capacity as bank employees or agents, therefore, are permitted to view an FDIC report, insofar as it relates to their scope of employment, without prior FDIC approval." The FDIC defines "agent" to include an accountant or accounting firm engaged by a bank's board of directors to perform an audit of the bank. Further, examiners are permitted to provide pertinent information to auditors with prior approval of the bank and with the understanding that, if the examination or the resultant report has not been completed, the examiner may not be in a position to be as conclusive as may be desired. Normally, a report is not issued until it has been reviewed by the Regional Director.

Any contact by an auditor with the FDIC should be through the Chief Review Examiner in the FDIC region in which the

bank is located, and only in rare cases would communication with the FDIC in Washington be necessary in this regard.

The FDIC also indicated that the auditor, with the permission of the bank, could attend exit conferences between examiners and either management or the board of directors of the bank. However, the FDIC indicated that it would expect the auditor to attend the meeting merely as an observer.

Representatives of the OCC indicated that national bank examination reports have been available to independent auditors since 1976 and the OCC will continue to make its reports available.

(The above response is consistent with an item in "The CPA Letter" dated December 12, 1983.)

.10 Bank Loan Disclosures

Inquiry—What disclosures should be made about negotiations to restructure crossborder loans made by U. S. banks to public and private sector borrowers in other countries and about loans to domestic troubled industries?

Reply—In late 1983, the SEC staff sent to the chairman of the AICPA banking committee the following statement of its views regarding disclosure that should be made about negotiations to refinance Brazilian debt. The staff's statement should be read in conjunction with SEC Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*, and Staff Accounting Bulletin No. 49A.

The Staff believes that the Brazilian debt restructurings are a matter that should be disclosed in current registration statements and annual reports on Form 10-K for fiscal year 1983 by any registrant whose crossborder outstandings to borrowers in Brazil exceed 1% of total assets. The narrative describing the Brazilian debt negotiations should state whether or not any amounts have been reported in the discussion (table) containing Item III. C. 1 of Industry Guide 3 information. In this connection, it is the obligation of the registrant to determine whether any Brazilian loans are included in Item III. C. 1.

The discussion of the negotiations should state the amount of the additional crossborder outstandings to public and private sector borrowers during the period being reported upon, and the amounts repaid during the same period broken down by amounts representing principal and interest. In addition, the amount of revenue reported as income on all Brazilian outstandings in the period being reported upon should be stated.

Industry Guide 3 is a broad document that applies to the description of the business portion of certain bank holding company registration statements. SAB No. 49A deals specifically with disclosures by bank holding companies about certain aspects of loans and other outstandings to public and private sector borrowers in countries that are experiencing liquidity problems. Among other things, these documents call for disclosures about the amounts and status of crossborder loans and other outstandings to borrowers in countries experiencing liquidity problems and about the potential effects of political and economic conditions that may affect the ability of borrowers in those countries to comply with the terms of their lending agreements. Additionally, disclosure of significant industry loan concentrations is required.

Although these disclosure requirements apply only to SEC registrants and to the nonfinancial statement portion of an SEC filing, all banks and bank holding companies must evaluate whether there is a need for financial statement disclosures such as material crossborder loans and loans to domestic troubled industries—consistent with requirements such as those contained in FASB Statement No. 5 on contingencies and FASB Statement No. 15 on troubled debt restructurings, if applicable—for managements to satisfy their assertions that the financial statements are in accordance with generally accepted accounting principles. Similarly, auditors must exercise their professional judgment in deciding whether informative disclosures in the financial statements meet the requirements of the third generally accepted standard of reporting and SAS No. 32.

(The above is consistent with an item in *The CPA Letter* dated December 26, 1983.)

.11 Accounting for Bank Deposit Float

Inquiry—Deposit float consists of checks deposited by customers that are in the process of collection and are currently not available for withdrawal. Beginning in mid-1983, many major banks questioned the historical practice of recording such checks as assets and liabilities. How should banks account for deposit float?

Reply—It is conceptually inappropriate to record deposits based on collections. Banks should continue to record deposit float as assets and liabilities.

(The above response is consistent with an item in *The CPA Letter*, dated September 24, 1984.)

.12 Accounting for Foreign Loan Swaps

Inquiry—Some United States Banks hold in their loan portfolios loans to borrowers in foreign countries or loans to foreign governments. Some of those loans are to debtors in financially troubled countries. Some banks have exchanged (swapped) such loans with other banks. Those types of transactions have raised the following questions:

1. Does a foreign loan swap represent a transaction that requires the recognition of a gain or loss and, if so, how should the gain or loss be measured?
2. How to establish current fair values?
3. Should a loss be a direct charge to income or to an allowance for loan losses?
4. How does the recognition of a loss on a loan swap transaction or management's decision to dispose of a loan before maturity affect the assessment of the adequacy of the allowance for loan losses and the carrying amount of the loan portfolio?
5. When should loss recoveries or gains be recognized?
6. Should fees and transaction costs in a loan swap be deferred and amortized?
7. If the swaps involve debtors in the same foreign country, are the answers to any of the above questions different?

Reply—1. A swap of loans to different debtors represents a transaction, i. e., an exchange of monetary assets, which should be accounted for by banks at current fair value. Normally, when monetary assets are exchanged, with or without additional cash payments, and the parties have no remaining obligations to each other, the earnings process is complete. The transaction may result in recognition of a gain or loss for either or both parties. The gain or loss is measured on the date of agreement to the exchange as the difference between (1) the amount of the recorded investment in the loan plus any cash or other consideration paid and (2) the current fair value of the loan plus any cash or other consideration received.

2. Establishing current fair values of loans to debtors in financially troubled countries usually will be difficult and sub-

jective because of significant uncertainties in the timing and amount of future cash flows. Further, there is presently no established market for such loans. Because of the highly judgmental nature of the valuation process in swap transactions, it would not be uncommon for two banks involved in a swap to reach a different conclusion on the value of the consideration (foreign loans) paid and received. It is the responsibility of bank management to make an appropriate valuation considering all of the circumstances. It is the responsibility of independent auditors to satisfy themselves that bank management has made an appropriate valuation using reasonable methods and assumptions, including, where appropriate, information from independent appraisals. Factors to consider in determining current fair values in the absence of an established market include the following:

- Similar transactions for cash;
- Market value, if any, of similar financial instruments;
- The credit standing of the debtor and/or guarantor, including prospects for reentry into the voluntary lending markets in the foreseeable future;
- Prevailing interest rates;
- Pricing options available (e. g., prime-based vs. London Interbank Offered Rate (LIBOR)-based loans);
- Anticipated delays in receipt of payments; and
- Tax consequences, including the effect of foreign withholding taxes on aftertax yields.

Certain foreign countries have experienced financial difficulties as evidenced by, for example, failure to meet scheduled interest and principal payments or failure to comply with International Monetary Fund (IMF) or other adjustment programs. Some accountants believe that, in an exchange involving loans to debtors in such countries, the estimated current fair value of the consideration received will generally be less than the recorded investment in the consideration paid.

3. If the current fair value of the proceeds of the swap is less than the recorded investment in the loan and other consideration paid, it is believed that a loss should be recognized and recorded at the date the transaction is agreed to by both parties. Whether the swap loss should be recorded as a direct

charge to income or as a loan write-off will depend on an evaluation of the facts and circumstances relating to the loan consideration paid and received. The following criteria should be used:

- A loss resulting from a change in the interest rate environment for similar loans (e. g., sovereign loans) should be recorded as a direct charge to income.
- A loss resulting from a major concern as to ultimate collectibility of the loan should be charged to the allowance for loan losses (whether or not specifically reflected in an allocation of such allowance).
- A loss which is not identified with either of the aforementioned factors should be recorded as a direct charge to income.

Losses charged directly to income should be included in the "other income" section of a bank's income statement and should be disclosed if material.

Auditors and management should be aware that the use of inappropriate accounting (i. e., charging losses directly to income which should have been charged to the allowance for loan losses) for swap transactions to avoid recording loan losses could be misleading to users of bank financial statements. The amount of loan losses, over time, is important data for stockholders, financial analysts, regulators and other readers of bank financial statements. Such data provide insights into the overall quality of a bank's credit portfolio and its ability to control credit risk.

4. In addition to recording specific transactions during an accounting period, a bank, in the course of preparing financial statements, must review the loan portfolio in order to assess the adequacy of the allowance for loan losses. In accordance with generally accepted accounting principles, a bank's loan portfolio should be carried at amortized historical cost less loan write-offs and the allowance for loan losses, as long as the bank has the ability and intent to hold the loans until their maturity. 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 swap loss which is unrelated to ultimate collectibility should not affect the assessment of the ultimate collectibility of remaining or new

loans to the same borrower. On the other hand, management may decide to dispose (by sale or swap) of a loan or a group 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. If management clearly demonstrates its intention to dispose of a loan or a group of loans prior to maturity, the loans should be carried at cost or market, whichever is lower.

5. Loss recoveries or 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 and the troubled financial condition of certain of the foreign debtors, it is believed that it would be inappropriate in most cases to record such loss recoveries or gains until the acquired loan is repaid in cash or its equivalent by the borrower. Similarly, unless timely collection in accordance with current terms is probable, any difference (i. e., discount) between the carrying amount and face amount of the loan received in the swap should not be accreted to income over the remaining life of the loan, but rather should be reported as income when the loan is collected or when timely collection in accordance with current terms has become probable.

6. No. All fees and transaction costs involved in a loan swap should be expensed when the swap transaction is complete. The new loan received in the exchange is initially recorded at its current fair value. If fees paid or transaction costs were deferred, it would cause the new loan to be carried at an amount greater than its current fair value.

7. No. Transactions may also occur involving debtors in the same foreign country. The general presumption is that if a substitution of debtors occurs, a monetary exchange has occurred which should be accounted for in the manner outlined above. However, when, for example, the foreign government is in substance assisting private sector borrowers by accepting loan payments in local currency to be converted at a later date into the currency needed to repay the loan at guaranteed exchange rates and the private sector borrower remains liable until ultimate repayment, a monetary exchange may not have occurred. Each transaction should be carefully evaluated, in light of the general presumption, to determine whether the

substitution is primarily a matter of form or of substance. It should be noted that a proposed Statement of Position (SOP), *The Definition of "Substantially the Same" for Debt Instruments*, has been developed. In connection with the forthcoming exposure of this draft SOP, it is intended that consideration will be given to whether swaps of loans with different U. S. foreign tax credit benefits which are otherwise "substantially the same" should be accounted for at current fair value. The SOP, when issued in final form, may contain additional guidance with respect to this issue.

(The above response is consistent with an item in *The CPA Letter* dated May 27, 1985.)

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Section 6110

Savings and Loan Associations

.02 Mutual Banks and Associations—Business Combination

Inquiry—Unlike a business entity, a mutual savings and loan association or a mutual savings bank does not have capital stock. How would a mutual savings and loan association or a mutual savings bank account for a business combination?

Reply—Although APB Opinion No. 16 does not refer specifically to combinations of mutual associations, it implies that its principles should be applied to such combinations. Further, the AICPA Audit and Accounting Guide, “Savings and Loan Associations,” provides that APB Opinion No. 16 applies to combinations of two or more mutual associations.

Some business combinations are accounted for by the pooling of interests method and others by the purchase method. APB Opinion No. 16 specifies criteria that must be met for a combination to qualify for the pooling of interests method. A combination that meets all the criteria that would apply to mutual organizations should be accounted for by the pooling of interest method. A combination not meeting all the applicable criteria should be accounted for by the purchase method. For example, a planned sale of a significant portion of the loan portfolio may cause the combination to be accounted for by the purchase method.

(The above response is consistent with an item in *The CPA Letter* dated January 11, 1982.)

.03 Mutual Banks and Associations—Valuation of Assets and Liabilities Acquired in a Purchase

Inquiry—Assuming a business combination for mutual savings and loan associations or mutual savings banks is accounted for by the purchase method, how should assets and liabilities be valued to conform with APB Opinion No. 16, paragraph 88?

Reply—According to APB Opinion No. 16 and FASB Interpretation No. 9, the assets and liabilities of an acquired mutual association should be stated at their fair values in business combinations of mutual savings and loan associations and similar institutions accounted for by the purchase method. Three areas of major concern are (1) stating the mortgage loan portfolio

at fair value, (2) stating the various savings deposits at fair value, and (3) identifying and measuring specifically identifiable intangible assets. Some considerations in those areas are:

- The purchase price is the fair values of the liabilities assumed plus the fair values of any other consideration given.
- The fair values of the loan portfolio, Government National Mortgage Association certificates (Ginnie Maes), and Federal Home Loan Mortgage Corporation Participation Certificates (Freddie Maes) should be determined by reference to their fair value in a bulk purchase.
- The discount resulting from the difference between the fair values and the unpaid principal balances of the loans and Ginnie Maes and Freddie Maes should be amortized using the interest method. The sum of the years digits method should not be used. If the discount is amortized over the estimated life of the loan portfolio as a whole rather than over the remaining terms of the individual loans in the portfolio, the life should be the remaining contractual term to maturity of the loans in the loan portfolio adjusted for expected prepayments. (APB Opinion No. 21, paragraph 15.)
- The fair values of regular savings and NOW account deposits should be the face amount plus accrued interest.
- The fair values of time savings deposits and borrowings should be determined using current interest rates for like deposits or borrowings resulting in discount or premium, which should be amortized using the interest method over the remaining terms of the liabilities.
- Consider the estimated future tax effects of amounts that are assigned to specific assets and liabilities. The existence of tax net operating loss carryforwards is one factor to consider in determining the amount of tax effects. (APB Opinion No. 16, paragraph 89.)
- Fair values should be assigned to specifically identifiable intangible assets whose fair values can be determined. Two such intangible assets to consider are (1) the capacity of existing mortgage loans and savings accounts of the acquired mutual association to generate future income or new

business and (2) the nature of the territory served by the acquired mutual association. Useful lives should be assigned to each separately identified intangible asset based on specific facts and circumstances. The fair values assigned become the cost of the assets, which should be amortized over those estimated useful lives.

- In the determination of the fair values the use of outside specialists may be necessary.
- Any amount that cannot be assigned to individual assets, including specifically identifiable intangible assets, less liabilities assumed, should be assigned to goodwill. FASB Statement No. 72, paragraph 5, specifies that goodwill should be amortized by the interest method over “the estimated remaining life of the long-term interest-bearing assets acquired,” or, “if the assets acquired in such a combination do not include a significant amount of long-term interest-bearing assets, . . . over a period not exceeding the estimated average remaining life of the existing customer (deposit) base acquired.”
- After a combination, the amortization periods for intangible assets, including goodwill, should be evaluated periodically to determine whether revised downward estimates of useful lives are warranted. See Statement No. 72, paragraphs 6 and 7.

(The above response is consistent with an item in *The CPA Letter* dated January 11, 1982, as modified by Statement No. 72.) [Amended]

.04 Mutual Banks and Associations—Determination of Acquiring and Acquired Company

Inquiry—How can an accountant determine which mutual savings and loan association or mutual savings bank is the acquiring and which is the acquired company?

Reply—APB Opinion No. 16 indicates that the identities of the acquiring mutual association and the acquired mutual association or associations are usually obvious and that the larger or the largest (usually measured by total assets) mutual association generally is the acquiring association. In the absence of persuasive evidence to the contrary, therefore, the acquiring mutual association is the larger or the largest of the combining associations.

(The above response is consistent with an item in *The CPA Letter* dated January 11, 1982.)

.05 Accounting for Loan Servicing Fees When Mortgage Loans Are Sold and Seller Retains Servicing Rights

Inquiry—Many thrift institutions that sell mortgage loans and retain the servicing rights have interpreted the AICPA Industry Audit and Accounting Guide—*Savings and Loan Associations*, to allow for gain or loss recognition on the sale of mortgage loans with deferral of an amount equal to the present value of future servicing costs. That accounting treatment differs from the treatment followed in the mortgage banking industry, where a normal servicing fee is deferred under the provisions of FASB Statement No. 65.

Which approach should be followed by savings and loan associations?

Reply—The Financial Accounting Standards Board issued Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, which, among other things, prescribes the accounting for loan servicing fees when mortgage loans are sold and the seller retains the servicing rights. The statement applies to mortgage banking and other enterprises, such as commercial banks and thrift institutions, conducting operations similar to the primary operations of a mortgage banking enterprise.

Paragraph 39 of the statement states that “. . . the Board decided that those principles (in SOPs No. 74-12 and No. 76-2) should apply to mortgage banking operations whether those operations are conducted by a mortgage banking enterprise or by another enterprise.” In addition, paragraph 45 of the statement specifically refers to transactions of this type engaged in by “enterprises in other industries.” Accordingly, the Institute’s accounting standards executive committee and the savings and loan committee believe that Statement No. 65 applies to mortgage banking activities of savings and loan associations and other enterprises and that the statement therefore requires thrifts and other enterprises to conform their accounting for those activities to the provisions of Statement No. 65.

(The above response is consistent with an item in *The CPA Letter* dated June 27, 1983.)

.06 Determination of Net Realizable Value of Certain Real Estate Transactions

Inquiry—Should interest be included as a holding cost in the determination of net realizable value of (a) real estate held for sale or development acquired in either troubled debt restructurings or other than by troubled debt restructurings and of (b) real estate that serves as collateral for doubtful or troubled loans and receivables?

Reply—A diversity in practice has resulted from different interpretations of the following sentence of the AICPA Audit and Accounting Guide—*Savings and Loan Associations*, page 41:

“ . . . The FASB has recently issued an exposure draft of a proposed statement of financial accounting standards, *Capitalization of Interest Costs* and any pronouncement ultimately issued is expected to be applicable to associations. . . .”

Certain associations have interpreted that language, when considered with FASB Statement No. 34, *Capitalization of Interest Cost*, as limiting the amount of interest to be included in the determination of net realizable value as a holding cost to that amount capitalizable under FASB Statement No. 34.

The issuance of FASB Statement No. 34 did not change the expressed conclusions in the Audit and Accounting Guide that all direct holding costs, including the cost of all capital (debt or equity) should be included in the determination of net realizable value of such real estate, regardless of whether such costs will be capitalized under FASB Statement No. 34.

(The above response is consistent with an item in *The CPA Letter* dated October 10, 1983.)

.08 Accounting for Loan Origination Fee Income Under a Federal Home Bank Board Rule

Inquiry—The guidance on recognition of loan origination fee income included in *The CPA Letter* dated March 10, 1980, appears to allow one percent of the amount of the loan plus \$200 for non-construction loans, and two percent plus \$200 for construction loans as current fee recognition, without cost justification, based on the Federal Home Loan Bank Board rule in effect prior to the amendment effective December 21, 1979. Is this a proper interpretation?

Reply—No. The AICPA Audit and Accounting Guide, *Savings and Loan Associations*, revised edition, sets forth the basic

principle that origination fees, to the extent they represent a reimbursement of origination costs, should be recognized in income at the time the loans are made and that any fees in excess of such costs should be accounted for as an adjustment of yield. Without changing this basic principle, the audit and accounting guide, page 74, did note that since determination of origination costs is difficult, fees allowable under the then (1979) Federal Savings and Loan Insurance Corporation (FSLIC) regulations could be recorded as income at loan closing. This approach was based on the conclusion in the audit and accounting guide that such fees generally did not exceed origination costs at that time. In view of the increased size of individual loans resulting from inflation and other factors, fees based on the pre-1979 FSLIC regulation now often may exceed origination costs and the assumption that such guidelines can still be used is not consistent with the basic principle in the audit and accounting guide.

There was no intention for the guidance issued on March 10, 1980, to deviate from the basic principle that current recognition of origination fee income is limited to the costs of origination. Under present generally accepted accounting principles, current origination fee income should be recognized only to the extent of actual origination costs.

(The above response is consistent with an item in *The CPA Letter* dated September 24, 1984.)

.09 Preferred Stock of Federal Home Loan Mortgage Corporation Received as a Dividend

Inquiry—The Financial Accounting Standards Board has stated that savings and loan associations who have received Federal Home Loan Mortgage Corporation preferred stock should account for the stock as a nonmonetary asset in accordance with APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, and the resulting income should be reported as an extraordinary item. Could recognition of the fair value of the preferred stock in the financial statements of a savings and loan association cause an uncertainty that would lead the auditor to qualify his opinion on the financial statements?

Reply—APB Opinion No. 29, paragraph 20, states that, “Accounting for a nonmonetary transaction should not be based on

fair values of the assets transferred unless those fair values are determinable within reasonable limits.” Statement on Auditing Standards No. 2, *Reports on Audited Financial Statements*, paragraph 21, states that, “matters are not to be regarded as uncertainties . . . unless their outcome is not susceptible of reasonable estimation.”

A decision to record a nonmonetary transaction at fair value in accordance with APB Opinion No. 29 means that the fair value of the assets involved is reasonably determinable and, for that reason, an auditor would not qualify his opinion on the financial statements because of an uncertainty regarding this matter.

Sources of evidential matter to support the fair value recorded in financial statements include the valuation report issued by an investment banking firm prior to distribution of the securities, and market prices indicated by trading of the securities on the New York Stock Exchange.

Also, the evidential matter supporting the transaction is not unique to each recipient, but applies to all recipients of the securities. Accordingly, the auditor’s judgment about fair values recorded would not be expected to vary other than “within reasonable limits.” Many institutions that have received this dividend are using \$40 per share as a fair value for the preferred stock at December 31, 1984.

(The above response is consistent with an item in *The CPA Letter* dated February 11, 1985.)

.10 Certain Real Estate Arrangements of Financial Institutions

Inquiry—Financial institutions may enter into real estate acquisition, development, or construction (ADC) arrangements in which they have virtually the same risks and potential rewards as those of owners or joint venturers. The institutions participate in expected residual profits in such arrangements. Some of those kinds of arrangements should not be accounted for as loans.

1. What is *expected residual profit*, and what are some forms of them associated with real estate ADC arrangements?
2. What are the characteristics of ADC arrangements implying an investment in real estate or a joint venture?

3. What are the characteristics of ADC arrangements implying a loan?
4. What effect would a personal guarantee have on the accounting treatment of an ADC arrangement?
5. What effect does *sweat equity* have on the accounting treatment of an ADC arrangement?
6. How should ADC arrangements be accounted for?
7. What other matters should be considered in accounting for ADC arrangements?

Reply—1. *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.

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.

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.

The profit participation agreement may or may not be part of the mortgage loan agreement. Consequently, the auditor

should be aware of the 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.

2. 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.

3. 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.

4. 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.

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.

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, some believe 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.

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, inquiries should be made as to other

guarantees. Also, it may be appropriate to obtain written representation from the guarantor regarding other contingent liabilities.

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.

5. 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*. It is believed that sweat equity is not at risk by the borrower at the inception of an ADC project. Consequently, 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.

6. The accounting guidance in this reply is based on a consideration of the characteristics in replies 2 and 3. A particular ADC arrangement may have one or more of these characteristics.

In the interest of more uniformity in accounting for ADC arrangements, 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 FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, and FASB Statement No. 66, *Accounting for Sales of Real Estate*.
- 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 a real estate joint venture, depending on the circumstances. At least one of

the characteristics identified in Reply 3, 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. SOP No. 75-2, *Accounting Practices of Real Estate Investment Trusts*, and the AICPA Audit and Accounting Guide entitled, *Savings and Loan Associations*, 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*, and FASB Statement No. 34, *Capitalization of Interest Cost*, as amended by FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, provide guidance for such accounting. In particular, SOP No. 78-9, paragraph 34, provides guidance on the circumstances under which interest income should not be recognized.

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.

7. 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, it is believed 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 FASB Statement No. 66 are met after giving consideration to the entire ADC arrangement including the continuing relationship between the financial institution and the project.

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 FASB Statement No. 66.

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 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.

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.

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, noncancelable 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 of the independent use of experts such as property appraisers or construction consultants to assist in the assessment of the collateral value.

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 above guidance. 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 the above replies. 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.

(The above response is consistent with an item in *The CPA Letter* dated February 10, 1986.)

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Section 6120

Credit Unions

.01 Modified Cash Basis Financial Statements

Inquiry—Is recording interest income on its outstanding loans when collected a generally accepted method of accounting for a credit union?

Reply—No. The AICPA Audit and Accounting Guide, *Audits of Credit Unions*, page 38, states that credit unions should include accrued interest receivable in their financial statements. [Amended]

.02 Applicability of FASB Statement No. 12, *Accounting for Certain Marketable Securities*

Inquiry—Does FASB Statement No. 12, *Accounting for Certain Marketable Securities*, apply to credit unions?

Reply—Yes. The AICPA Audit and Accounting Guide, *Audits of Credit Unions*, page 21, states adjustments would be required to the carrying amounts of certain securities in conformity with FASB Statement No. 12. [Amended]

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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 the income from discounts on such loans?

Reply—In determining income from loans receivable which have been issued at a premium or discount, the fairest measure of income requires that any such premium or discount be amortized on the “true interest” method, rather than on the straight-line method. However, because the resulting computations by small loan companies might involve an undue burden of record keeping, the Accounting Principles Board, in paragraph 3(d) of its Opinion No. 21, excluded companies which are involved in making cash loans from all requirements other than paragraph 16 of the Opinion. The majority of loans of such companies are for relatively short periods, and, therefore, the effect on income of using the straight-line method (rather than true interest) would generally not be material.

.02 Method of Recognizing Revenue from Finance Charges

Inquiry—A finance company has a policy of recognizing 15% of the finance charges on loans as revenue in the first month of the loan. The balance of the finance charges are reported as earned as the receivable is liquidated. Is this an acceptable method of recognizing revenue from finance charges?

Reply—The AICPA Industry Audit Guide, *Audits of Finance Companies* (1973), discusses finance income in Chapter 2. Page 25 indicates that the portion of deferred finance income attributable to acquisition costs is transferred to income in the month the loan is recorded if all such costs are recorded under the combination method at that time. Page 28 states, “The Committee believes that amounts equivalent to estimated acquisition costs credited to income in the month loans are recorded (transfers) should not include cost elements which cannot be accurately measured and controlled.” Page 36 of the guide states:

The Committee believes that the most theoretically desirable objective is to account for all income from lending operations on the com-

bination method [see pages 24-35] and that this method is preferable in accounting for income earned on discount-basis finance receivables. However, at present, the practicality of this matter has not been sufficiently established, and for this reason the combination method should not now be designated as the only acceptable method.

.03 Method of Recognizing Revenue from Service Charges

Inquiry—A company finances insurance premiums for 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 "Rule of 78s."

How should the service charge be recognized on the records of the company?

Reply—Page 19 of the AICPA Industry Audit Guide, *Audits of Finance Companies*, indicates, "Deferred finance income includes all charges (fees) to borrowers made at the origination of the loan, notwithstanding that some portions may be non-refundable." The committee's conclusions regarding acceptable methods of recognizing deferred finance income begins on page 36 of the guide.

The service charge should be deferred. Whether or not the "Rule of 78s" method would be acceptable depends on the initial maturity of the loans. As indicated on page 37 of the guide, the "Rule of 78s" should be limited to loans of not more than 84 months.

.04 Method of Recognizing Revenue from Commissions on Loan Insurance

Inquiry—A finance company receives commissions for loan insurance. The company follows a policy of recognizing the commissions as the policies are written. Is this the proper method of recognizing commission revenues?

Reply—Page 61 of the AICPA Industry Audit Guide, *Audits of Finance Companies* (1973), indicates insurance commissions received by finance companies from affiliated insurance companies or from independent insurers should be credited, when received, to a deferred income account and systematically transferred to income over the life of the related insurance contracts. The method of commission amortization should be consistent

with the premium income recognition methods described in the two insurance Industry Audit Guides dealing with stock life insurance and fire and casualty insurance companies.

.05 Disclosure of Contractual Maturities of Direct Cash Loans

Inquiry—AICPA Industry Audit Guide, *Audits of Finance Companies* (1973), page 74, calls for disclosure of contractual maturities of direct cash loans. At December 31, 1974, 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: 1975, \$66,000; 1976, \$30,000; and 1977, \$12,000. Refer to page 85 of the Industry Audit Guide, *Audits of Finance Companies*, for an illustration of such disclosure.

.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—AICPA Industry Audit Guide, *Audits of Finance Companies* (1973), states on pages 68-69:

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.

Therefore, the proposed balance sheet presentation would not be acceptable even if the financial statements are clearly and conspicuously labeled, "For the Use of Banks and Bankers Only." [Amended]

.07 Accounting for Non-refundable Discounts on Long-Term Loans

Inquiry—What is the appropriate accounting treatment for discounts on long-term loans? Do generally accepted accounting principles permit non-refundable discounts to be reported as income when the loans are made, or should they be amortized over the life of the loan? How should the change in accounting principle be reported if the discounts should have been amortized, and were recognized as income at the time when the loans were made in prior years?

Reply—Page 36 of the AICPA Industry Audit Guide, *Audits of Finance Companies*, discusses deferred finance income and states, in part:

The Committee believes that the most theoretically desirable objective is to account for all income from lending operations on the combination method and that this method is preferable in accounting for income earned on discount-basis finance receivables.

The combination method is discussed starting on page 24 of the guide. This method results in matching costs with revenues more closely than any of the other methods studied by the committee, and relates the accounting for finance income to all elements of cost incurred in connection with the loans. The non-refundable discounts should be amortized over the life of the loan since they are adjustments of the interest rate, and do not relate to acquisition and other costs applicable to the loan discussed under the combination method in the guide. If the application of this method results in an accounting change, APB Opinion No. 20 and page x of the guide describe how to account for the change.

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Section 6200

Regulated Industries

.01 Deferral of Purchased Power Expense by Public Utilities

Inquiry—A nuclear power plant closes down each summer for refueling and maintenance, and occasionally the plant closes down when radiation exceeds the allowable level. The cost of this downtime is a purchased power expense to electric utility companies which have contracted to buy power.

The State Public Service Board permits a reporting utility to recover the costs over a ten-year period from customers by including the costs in the rate base. Is it proper accounting for the electric utility companies to defer the purchased power expense caused by downtime of the nuclear plant?

Reply—General accounting standards for the effect of regulation are discussed in FASB Statement No. 71. If, as required by FASB Statement No. 71, paragraph 9, it is probable that future revenues of the utilities will be sufficient to recover the downtime costs, the costs should be deferred. [Amended]

.02 Recognizing Revenues by Public Utilities Using Cycle Billing

Inquiry—A public utility uses cycle billing in billing its customers. How should the unbilled revenues be reported?

Reply—Included in the Federal Power Commission chart of accounts for electric utilities is Account No. 173, “Accrued Utility Revenues.” This is an optional account which may be used to record power delivered to customers but not yet billed at the month end. The FPC requires that, if such an account is used, provision also be made for any purchased power received but not yet accounted for.

One utility estimates its unbilled revenues by taking the cycles of the following month and allocating to the prior month the portion of the aggregate billings for that cycle, based on days elapsed. For any cycles for which data was not available by the date the entry was needed, an estimate was made using the billing of the previous month for that cycle. However, other

methods may be devised to provide a reasonable estimate of revenues earned but not billed at the month end.

.03 Financial Statement Presentation of Power Service Rights by Electric Cooperative

Inquiry—A client is an electric cooperative. The cooperative borrows funds from the Rural Electrification Administration and by doing so is subject to certain accounting procedures required by the REA.

The cooperative has paid for rights to build its lines into certain areas to provide future tenants with electricity. The rights, which are usually granted by developers, may either run for an indefinite period or may run for a limited term, such as ten years. The contracts provide for general rights-of-way into the areas, but no specific deeds or easements are granted.

The auditors believe that these rights benefit future periods, and the costs to gain these rights should be capitalized. The REA, on the other hand, has taken the position that, since no specific titles are recorded, the expenditures are similar to promotion and advertising costs and should be expensed. How should the rights be presented on the financial statements?

Reply—If the costs in question were incurred as part of a bidding process to acquire the right to build lines into certain geographical areas to provide future tenants and/or owners with electric power, they may be appropriately capitalized under generally accepted accounting principles and APB Opinion No. 17 would apply. Otherwise, they should be expensed. [Amended]

»»»→ *The next page is 5521.* ←«««

Section 6300

Insurance Companies

.01 Recognition of Commission Income by Insurance Agency

Inquiry—When an insurance agent arranges for one of the insurance companies that he represents to underwrite an insurance policy for one of his insureds, he issues a policy and a bill for the premium to the insured and he is entitled to a commission from the insurance company. The insurance policy is usually for at least one year and, if it is cancelled, the insurance company will charge back to the agent a portion of his commission related to the unearned premium.

How should the commission be recognized in the income statement?

Reply—In general, commissions are recognized as revenues at the effective date of the policy because the agent ordinarily has substantially completed his service at that date. Management of the agency recognizes commission revenue at the later of the effective or the billing date, but the effective date seems to be a more objective date.

A charge-back for a portion of the commission on cancellation of a policy is usually recorded when the agent or broker is notified and billed by the insurance company. In some circumstances, however, it might be possible to estimate and accrue the commission adjustments in advance, in accordance with FASB Statement No. 5, *Accounting for Contingencies*.

Some insurance companies bill the insured directly rather than have the agent send the invoice. Generally, commissions on these direct billings, as well as contingent commissions, are recorded when they are received from the insurance company because the agent ordinarily lacks the information to estimate and accrue those amounts. [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.

.06 Accounting and Disclosure for Reinsurance Transactions

Inquiry—Under certain reinsurance transactions in the property and liability insurance industry, often referred to as portfolio loss reserve reinsurance arrangements or “sales of loss reserves,” property and liability insurance companies cede loss reserve liabilities to assuming reinsurers together with the payment of an amount that is generally less than the total estimated future payments required to liquidate the claims.

How should this type of transaction be reported and disclosed in the financial statements?

Reply—FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, paragraph 40, requires: “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.” FASB Statement No. 5, *Accounting for Contingencies*, paragraph 44, includes a similar requirement that the contract provide for indemnification of the ceding enterprise against loss or liability in order for amounts to be charged or credited to income.

Often, the exercise of judgment is necessary in determining whether a reinsurance contract provides for indemnification of the ceding enterprise by the assuming reinsurer against loss or liability. Circumstances that may indicate the absence of such indemnification include, but are not necessarily limited to, the following:

- Contractual provisions that provide for a significant period of time before the reinsurer is required to reimburse the ceding enterprise.
- Contractual provisions that relieve the assuming reinsurer of its obligations under circumstances that are likely to occur.
- The existence of retrospective rating, expense, or profit-sharing arrangements.
- A reinsurer with insufficient financial resources to satisfy its obligations under the reinsurance contract.

The auditor also should be mindful of Statement No. 60, paragraph 60f, which requires disclosure in the financial statements of the nature and significance of reinsurance transactions to the insurance enterprise's operations.

(The above is consistent with an item in *The CPA Letter* dated January 23, 1984.)

.07 Liability for Unasserted Claims

Inquiry—FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, paragraph 9, states:

Premiums from short duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of protection provided. A *liability for unpaid claims* (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a *liability for claim adjustment expenses* shall be accrued when insured events occur.

Should a for profit Health Maintenance Organization (HMO) record a liability for covered claims which have occurred but which have not been reported because neither the insured nor the insurer is aware of the "occurrence" (e. g., an undetected cancer)?

Reply—A recent AICPA Issues Paper, “Accounting by Health Maintenance Organizations and Associated Entities,” paragraph 32, discusses how an HMO should recognize the cost of health care services. The paper concludes that HMOs should accrue health care costs as services are rendered, including estimates of incurred but not yet reported costs (IBNR) to the HMO.

Estimates of IBNR may be determined based on the HMO’s own experience or it may be based on an industry average, if the HMO does not have sufficient experience, providing the HMO has reason to believe that its experience will be similar to the industry experience.

➤ *The next page is 5641.* ←➤

Section 6400

Hospitals

.01 Combined or Separate Financial Statements for Individual Funds

Inquiry—A hospital has an endowment fund, a development fund, and an operating fund. Should the financial statements for these funds be combined, or may separate reports be issued?

Reply—The AICPA Industry Audit Guide, *Hospital Audit Guide*, gives an example of the statement of financial position of a hospital in Exhibit A on pages 40-41. In this example, a clear distinction is made between restricted funds and unrestricted funds. The restricted funds on the balance sheet are not combined in the sense of being added together, but are shown as separate funds on a single statement. While not prohibited, issuing separate reports on the funds, especially on a development fund, may be somewhat misleading without reference to the other funds because of possible inter-fund transfers.

.02 Combined Financial Statements of Related Tax-Exempt Corporations

Inquiry—Two tax-exempt corporations jointly operate a hospital. One corporation is in charge of the hospital's health care activities, and the other corporation is a support organization managing the hospital's endowment funds, building funds, and board-designated unrestricted funds. The two corporations are separate and distinct entities, but they share a common board of trustees. Is it necessary, on the financial statements of the hospital, to combine the funds of these two organizations?

Reply—In the AICPA's *Hospital Audit Guide*, page 3, the Committee on Health Care Institutions unanimously concluded that financial statements of hospitals should be prepared in accordance with generally accepted accounting principles. Accordingly, Financial Accounting Standards Board Statements, Accounting Principles Board Opinions, and Accounting Research Bulletins presently in effect or subsequently issued should be applied in reporting on hospital financial statements unless they are inapplicable. The FASB Statements, APB Opinions, and Accounting Research Bulletins generally apply to profit-oriented business enterprises, and often are not applicable to nonprofit organizations. However, the relationship between

the hospital corporation and the supporting corporation under the common control of a board of trustees is very close to the type of situation that would require combined financial statements under ARB No. 51. In addition, the hospital corporation and the supporting corporation appear to come within the meaning of related organizations referred to in the *Hospital Audit Guide*, pages 11 and 12. Therefore, the financial statements of the hospital corporation and the supporting corporation should preferably be presented on a combined basis.

.03 Designation of Income from Endowment Fund

Inquiry—The AICPA Industry Audit Guide, *Hospital Audit Guide*, states that restricted and unrestricted funds should be reported separately on the financial statements, while funds which are not directly or indirectly controlled by the hospital should not be included in the financial statements but should be disclosed in a note.

The income of an endowment fund which is not controlled by the hospital is unrestricted according to the trust instrument. Accordingly, the endowment fund trustees periodically remit a check for the income earned to the hospital. The hospital treasurer, who is a member of the hospital's governing board, has been endorsing these checks back to the fund with the instructions that the proceeds be added to the fund principal.

Is the income of the endowment fund restricted, unrestricted, or controlled?

Reply—The *Hospital Audit Guide*, page 8, discusses board-designated funds. Such funds are included in unrestricted funds on the financial statements of the hospital.

Once the endowment fund trustees remit the endowment fund income to the hospital, the funds are available for the hospital's general use. Where checks are endorsed back to the endowment fund with instructions to add the amount to the endowment fund principal, the money represents a board-designated fund and should be accounted for as discussed on page 8 of the audit guide.

.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 hospi-

tal. 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 fees of the physicians be included in the income and expenses of the provider hospital?

Reply—The portion of the compensation of physicians (except interns and residents under approved training programs) applicable to professional services rendered to patients is treated differently from other provider costs. In the instance cited above, the hospital may be functioning as a conduit with respect to the fees in question, in which case they can be reported directly as a liability to the physicians and not recognized in the income statement as either income or expense.

.06 Presentation of Medicare Financing Payments

Inquiry—A voluntary hospital receives medicare financing payments. The hospital auditors use the net receivables approach to indicate current financing. Other hospitals show medicare current financing payments as a current liability on the balance sheet.

Are both methods of presentation acceptable?

Reply—The sample balance sheet on page 40 of the AICPA Industry Audit Guide—*Hospital Audit Guide*, includes advances from third-party payors as a current liability. Page 24 of the Audit Guide indicates that liabilities would include amounts due to third-party payors for working capital advances and for over-reimbursement. Medicare current financing payments are considered the same as working capital advances from third-party payors. While showing the current financing payments as a current liability is the recommended approach in the Audit Guide, the practice of reporting these payments as a reduction of accounts receivable is still acceptable within the industry, and independent auditors generally would not consider this alternative presentation as a departure from generally accepted accounting principles.

.07 Accounting for Reimbursement from Medicare in Excess of Standard Rates

Inquiry—A hospital records its revenue for services under the medicare program at a standard rate. An accumulated allowance for uncollectibles has been established for those standard charges for services which the medicare program will not reimburse the hospital.

If the hospital is reimbursed for more than its estimated revenue receivable, should this excess be included in the account "Revenue from patient services" or in "Other revenue"?

Reply—Hospital revenue consists mainly of the value at the hospital's full established rates of all hospital services rendered to patients regardless of the amounts actually paid to the hospital by or on behalf of the patients.

An account titled "Contractual Adjustments" can be set up and charged with the differential between the amount, based on the hospital's full established rates, of contractual patients' bills for hospital services covered by a contract and the amount received from third-party agencies in payment of such services. Should the hospital receive more than its established rates from an agency, the differential is credited to this account.

The account "Other Revenues" should be reserved for the recording of all revenues other than those that are directly associated with patient care.

.08 Qualification of Auditor's Opinion for Uncertainty in the Amount of Medicare Reimbursements

Inquiry—A client, a hospital, prepares its own annual cost report to be filed for Medicare reimbursements. The client, however, never prepares this cost report until long after the annual audit is completed, since the auditors use the final audit figures in preparing the report. For this reason, at the time of concluding the audit work, the auditors are unable to estimate how much, if any, reimbursement will be received from Medicare for the year or if the hospital might even be required to refund certain monies.

Delaying the issuance of the audit report until this additional factor is known would cause considerable difficulties in meeting various deadlines such as the annual meeting of the members of the hospital corporation which must be held within three months

of the close of the fiscal year. The Medicare cost report is very seldom prepared before the 90-day limit which has been set by Social Security Administration, and many times is filed late.

Is it necessary for the auditor to qualify his opinion because of this uncertainty?

Reply—If the difference between the ultimate amount of reimbursement under Medicare and the related amounts included in the financial statements on which the auditor is reporting is of sufficient magnitude to materially affect the financial statements, it would appear that qualification or disclaimer of opinion in accordance with SAS No. 2, paragraphs 23-25 would be appropriate. However, in most cases, accountants have been able to arrive at estimates of such reimbursements sufficiently reliable so that a qualified opinion would not be necessary.

.09 Financial Statement Presentation of Claims for Reimbursement Subject to Adjustment

Inquiry—A private hospital has entered into contracts with Blue Cross and Medicare whereby the hospital will provide services for all patients covered by these insurers. Periodic cost reports are filed with the insurers, but reimbursements are usually delayed almost two years pending a field audit of the hospital. These audits usually result in downward adjustments of the hospital's claims. In addition, the claims are subject to various ceilings which are set after the claims are filed.

Since it is not possible to estimate the amount that will actually be received, how should these claims be reported on the hospital's financial statements?

Reply—The amount of income to be recognized should be based upon the most realistic estimates available at the date of the report.

The difference between estimated recoveries from such providers and the amounts eventually received will frequently be large enough to require separate presentation in the financial statements. Such an adjustment is a "change in accounting estimate" as discussed in APB Opinion No. 20, paragraphs 10 and 11 and 31 through 33. Since such adjustments are, by their nature, recurring items, they do not fit the criteria for an extraordinary item as discussed in APB Opinion No. 30, para-

graphs 19 through 23. The billings to the providers which are still subject to settlement should be disclosed in the notes to financial statements. Such disclosure is shown in the AICPA Industry Audit Guide, *Hospital Audit Guide*, page 48:

NOTE 3: Revenues received under cost reimbursement agreements totaling \$4,000,000 for the current year and \$3,000,000 for the prior year are subject to audit and retroactive adjustment by third-party payors. Provisions for estimated retroactive adjustments under these agreements have been provided.

.10 Applicability of AICPA Hospital Audit Guide to a City-Owned Hospital

Inquiry—A hospital is generally self-supporting through revenue billed to patients. The hospital receives contributions from the city to help defray employee retirement costs, as well as an amount from general property taxes. Construction costs have been financed through revenue and general obligation bonds. Would the Institute's *Hospital Audit Guide* apply to this city-owned hospital?

Reply—The Institute's *Hospital Audit Guide* would apply. Hospitals are classified in the *Hospital Audit Guide*, page 1, as voluntary, governmental, or proprietary, and the Audit Guide would apply to each.

.11 Funds Received from State for Medical School

Inquiry—A teaching hospital, which supports a state university medical school, receives appropriations from a state educational trust fund for "the support of public education in the State." Are such appropriations regarded as a restricted fund under the AICPA Industry Audit Guide, *Hospital Audit Guide*?

Reply—The *Hospital Audit Guide*, pages 8 and 9, state in part:

Many hospitals receive, from donors and other third parties, gifts, bequests, and grants that are restricted as to use. These generally fall into three categories: (1) funds for specific operating purposes, (2) funds for additions to property, plant, and equipment, and (3) endowment funds.

Funds for specific operating purposes consist of donor-restricted resources and should be accounted for in a restricted fund or as deferred revenue in the unrestricted fund. These resources should be reported as "other operating" revenue in the financial

statements of the period in which expenditures are made for the purpose intended by the donor.

Therefore, amounts received from the educational trust fund would appear to be a restricted fund.

However, it would be advisable to get a ruling from the State Attorney General as to whether payments from the educational trust fund are intended to be restricted to paying certain expenses.

.12 General Obligation Bonds Issued for Current Use by City Owned Hospital

Inquiry—A certain 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 for the payment of principal or interest on the bonds. Should the general obligation bond liability be reported on the hospital financial statements?

Reply—No. The AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units*, page 104, states that government operated hospitals should follow the guidance in the AICPA Industry Audit Guide, *Hospital Audit Guide*. According to the audit guide, page 7, contributions that are not restricted by donors should be reported as nonoperating revenue. In this situation, the proceeds from the bond issue are contributions from the city; the hospital has no obligation to make any payments of principal or interest on the bonds. Therefore, the hospital need not report the bonds as a liability in its financial statements. It should record the city's contribution as a part of nonoperating revenue. However, since the amount of the contribution is material to the financial statements, it should be disclosed separately.

➤➤➤ *The next page is 5741.* ←➤➤➤

Section 6410

Nursing Homes

.02 Deferral of Reimbursement Income Due to Difference in Depreciation Methods

Inquiry—A nursing home has a contract to accept medicare patients. The cost reimbursement for the building that it receives from medicare is computed by using the double declining balance and a life of thirty-three years. The company has recently been acquired by a public company, and audited statements are now required. On these statements an election can be made to use the straight line method of depreciation for the equipment and building and a life of forty years on the building.

Should there be an account for the deferred income from medicare which would be derived by recomputing the medicare cost with straight line depreciation?

Reply—Deferred income (or expense) results from a timing difference between the periods in which depreciation affects reimbursement revenue and the periods in which it enters into the determination of the results of operations. When depreciation for reimbursement purposes exceeds depreciation for financial reporting purposes, income should be deferred to the extent that it is attributable to this excess depreciation.

.03 Accounting for Home Office Management Team Costs and Revenues

Inquiry—A company owns and operates nursing home subsidiaries. The parent company maintains a management team which provides accounting and management services for each subsidiary. Each subsidiary reimburses the parent company for the cost of these services.

In addition to the monthly recurring function of the home office management team, team members are involved in (1) searching for and obtaining financing of new nursing home subsidiary acquisitions, (2) developing plans for constructing new nursing homes, (3) developing plans for expanding presently owned nursing home subsidiaries, and (4) providing management consulting services to outside unrelated organizations. What would be the recommended accounting treatment for expenses incurred

(and revenue generated) by the management team in connection with these activities?

Reply—The costs related to the search for new acquisitions should be expensed as incurred in accordance with Interpretation 33 to Accounting Principles Board Opinion No. 16 which discusses costs of maintaining an “acquisitions” department.

Costs related to constructing the new nursing homes should be allocated to the new homes. Costs related to the expansion of presently owned nursing home subsidiaries should be allocated to these subsidiaries. Capitalization would not seem appropriate for items (2) and (3) because these are normal management activities.

Revenues of the home office management team in connection with services provided to unrelated organizations should be reported as miscellaneous revenue and the expenses deducted as incurred.

➤→ *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 no 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 foot-

note 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.

➡ *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.

.02 Method of Recognizing Revenue from Sales of Condominiums

Inquiry—A company is presently constructing the first section of a condominium development. This condominium includes detached single-family homes, one story multi-family units, and three story buildings. There are no rental units in this development. All property of the development will be owned equally by the individual members of the community. However, the land directly underneath the single-family detached homes is owned by the owner of the dwelling; and, in the case of multi-family units and the three story buildings, the land directly under these buildings is owned jointly by the owners of the units in the building.

Can the percentage of completion method be used for profit recognition for all dwellings, or must income be reported on the sales of single-family or one story multi-family units at the closing date?

Reply—If all the conditions as outlined in FASB Statement No. 66, *Accounting for Sales of Real Estate*, paragraph 37, are met, the percentage of completion method may be applied to each unit sold as a condominium.

.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, 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 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. [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), 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.

.08 Work Performed By Purchaser

Inquiry—As part of an agreement relating to the sale of a single family house, the purchaser agreed to make certain repairs to the property. Can the work performed by a purchaser be considered as a partial down payment?

Reply—No. FASB Statement No. 66, *Accounting for Sales of Real Estate*, paragraph 10(a), states that payments by the buyer

to third parties for improvements to the property should not constitute a down payment. Similarly, costs for repairs that the buyer incurred do not constitute a down payment.

➤ *The next page is 6041.* ←

Section 6610

Retail Land Sales Companies

.01 Financial Statement Presentation of Real Estate Developer

Inquiry—A real estate developer would like to present a balance sheet with no classifications as to current or noncurrent assets and liabilities. The statement of changes in financial position would also have to have a somewhat amended format. Is such a presentation permissible?

Reply—Yes. APB Opinion No. 19, *Reporting Changes in Financial Position*, paragraph 9, states in part:

The Board recognizes the need for flexibility, in form, content, and terminology of the Statement to meet its objectives in differing circumstances. For example, a working capital format is not relevant to an entity that does not distinguish between current and noncurrent assets and liabilities.

Under the circumstances the statement could reflect sources and uses of cash (see APB Opinion No. 19, paragraph 11).

The first sentence of the Auditing Interpretation entitled *Long Term Investments*, paragraph 13, section 9332.13 of *AICPA Professional Standards*, Volume 1, confirms the appropriateness of the use of unclassified balance sheets in some industries, such as insurance, investment, finance, and real estate. [Amended]

.02 Accounting for the Cost to Reacquire Land Sales Contracts by the Seller

Inquiry—In recent times of escalating land values, there have been instances when a land contract has been reacquired by the seller for a price in excess of the original contract in order to accumulate enough contiguous tracts to make an outright sale at the current market level.

How should the cost of reacquiring land sales contracts be treated?

Reply—Accounting for the cost to reacquire land contracts is not discussed in FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. There are differing views of how to account for these costs. One view

is that the land should be restored to inventory at its original cost, and any additional costs of reacquiring the contract should be treated as a current period expense. This viewpoint is based on the theory that such costs represent an expense incurred to cancel the contract. Another viewpoint is to treat the cost of reacquiring the contract as a capitalizable cost. This point of view is based on the theory that the contract for deed represents a claim on the land, and the costs are incurred to perfect the seller's interest in the property.

Perhaps the reasonable approach would be to treat costs to reacquire the contract for deed as expenses unless it can be clearly demonstrated that they are costs incurred to sell real estate projects that can be capitalized as prepaid costs if they are directly associated with and their recovery is reasonably expected from sales that are being accounted for under a method of accounting other than full accrual. (See FASB Statement No. 67, paragraph 18.) [Amended]

.03 Disclosure of Appraisal Value of Land Held for Resale or Development

Inquiry—A real estate development company would like to reflect appraised values of land held for resale or development in its financial statements. This would not only increase asset valuation but enhance loan capability. Is there any authority for use of appraisal values?

Reply—Cost is the proper basis for presenting land in the financial statements of the developer. As indicated in APB Opinion No. 6, "... 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." In addition, ARB No. 43, Chapter 4, indicates that:

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. 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.

Therefore, cost is the proper basis for balance sheet presentation in the financial statements. However, footnote or other supplementary disclosure of the land's appraised value, and the basis of the appraisal, may be useful information to the reader of the financial statements. [Amended]

.04 Allocation of Land Costs to Parcels Sold

Inquiry—A land development company presently charges 10% of the selling price of a homesite as the cost of sales. Historically the cost of sales ratio to sales has ranged from 10% to 29%. Is a 15% experience rate for cost of sales appropriate?

Reply—The land costs should be allocated to lots sold based on the most recent actual experience of the company and in accordance with FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, paragraph 11. Paragraph 11 states:

The capitalized costs of real estate projects shall be assigned to individual components of the project based on specific identification. If specific identification is not practicable, capitalized costs shall be allocated as follows:

- a. Land cost and all other common costs (prior to construction) shall be allocated to each land parcel benefited. Allocation shall be based on the relative fair value before construction.
- b. Construction costs shall be allocated to individual units in the phase on the basis of relative sales value of each unit.

If allocation based on relative value also is impracticable, capitalized costs shall be allocated based on area methods (for example, square footage) or other value methods as appropriate under the circumstances. [Amended]

➤➤➤→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, 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, 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]

.05 Classification of Profit on Uncompleted Negotiated Contracts

Inquiry—A building contractor derives most of his income from negotiated contracts rather than firm bid contracts. On negotiated contracts, the contractor renders a statement to each client which includes itemized costs for a period plus an 8% fee. Later, the client remits a check for the amount of the progress billing less a 10% or 15% retainage. Previously, ARB No. 45, *Long-Term Construction-Type Contracts*, was construed to apply to the negotiated contracts, and the profit on uncompleted ne-

gotiated contracts was shown among current liabilities as "Billings on Uncompleted Contracts in Excess of Related Costs." Now it is proposed to classify the profit on uncompleted negotiated contracts as deferred income. Is such a classification proper?

Reply—ARB No. 45, paragraph 1, specifically states that "It does not deal with cost-plus-fixed-fee contracts, which are discussed in Chapter 11, Section A, of Accounting Research Bulletin No. 43. . . ." The provisions of Chapter 11A are equally applicable whether the profit is fixed in dollars or as a percentage of costs.

ARB No. 43, Chapter 11A, paragraphs 13 and 16—18, indicate that, under usual conditions, billings for the profit portion of such contracts should be credited to income currently. If there is reason to believe that there will be claims presented against the 10% or 15% retainage, an appropriate allowance for losses on receivables should be provided.

.06 Effect of Retainages on Percentage of Completion Method

Inquiry—A contractor accounts for income from long-term contracts on the percentage-of-completion basis. The contracts involve retained percentages. The contractor proposes to include the retained percentages in income in the year received rather than the year earned and to show the retained percentages on the balance sheet as a current asset and as a noncurrent deferred income item until received. Is the accounting for retained percentages proposed by the contractor correct accounting?

Reply—Billings by construction contractors usually provide for the customer retaining a certain percent (frequently 10%) of the billing to ensure completion of the job and correction after such completion of any defects in the work which may subsequently be discovered. Such retainages will be returned upon final acceptance, which frequently is a year or more after completion of the job.

If the completed-contract method of accounting is being used, profit on the contracts is normally recognized when all billings have been completed, although the adjustments and additional work for which the retainage is withheld have not yet been made. Under such conditions, appropriate provision should be made for the liability to complete the work. This is not a "deferred credit" but an actual liability to do work, and usually should be less than

the amount of the retainage. This estimate of costs to complete will be shown as a current liability.

Under the percentage-of-completion method, there is no basis for excluding the portion of the contracts represented by the retainage from calculation. At the completion of the regular work on the contract, the estimated cost necessary to make corrections, repairs, etc., would be a measure of the uncompleted portion of the contract at that date. The ratio of this amount to total cost should be applied to the total amount of the contract (including the retainage) to determine the amount of profit on the contract to be recognized to date. The effect would therefore be to show as a current asset the amount of retainage less estimated costs to complete and also less the portion of the profit allocable to such cost.

.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.

»»→ The next page is 6351. ←««

Section 6910

Investment Companies

.01 Valuation of Securities at Cost or Fair Value

Inquiry—A two-shareholder venture capital corporation is capitalized for under \$100,000 and leveraged from stockholder loans in excess of a 50:1 debt-equity ratio. The company's business consists of providing funds in the form of loans, equity, or a combination of loans and equity to companies with no public market for their securities. Also, the company sometimes provides management supervision to its investees.

The company's equity investments are typically in companies which have a limited operating history. Valuation of such equities, notwithstanding the care, good faith, and expertise of those involved in the valuation process, is difficult at best. Because of the uncertainty concerning the value of the investments, it seems likely that if all equities were carried at value there would be very large changes from year to year in unrealized appreciation.

Can the company present its securities at cost on the balance sheet with the company's estimate of the value of the equities disclosed in a footnote to financial statements?

Reply—The company's securities should not be valued at cost, but at estimated fair value as discussed in the AICPA Industry Audit Guide, *Audits of Investment Companies* (1973), pages 16 and 17, 35 through 37, and 46 through 48. If the company insists on valuing the securities at cost, an opinion similar to that shown on pages 111 and 112 would be required to be expressed by the auditor.

.03 Basis for Valuation of Investments in Rental Property

Inquiry—A client, an investment company, has substantial investments in assets other than securities, particularly rental real estate. The AICPA Industry Audit Guide, *Audits of Investment Companies* (1973), seems to discuss 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 Industry Audit Guide, *Audits of Investment Companies*, states that, in general, all investment companies should report their security investments at value. This principle would also apply to the rental property in this client's portfolio.

Pages 109-110 of the guide contain an example of a form which may be used for expressing an opinion on financial statements in which there is a material portion of securities valued "in good faith" by the board of directors and for which the auditor has examined documentation supporting such securities valuation and found nothing to indicate that the valuation principles are not acceptable or have not been consistently applied or that the valuation is not reasonably supported by competent evidential matter (also see page 48 of the guide).

The SEC's Codification of Financial Reporting Policies, Sec. 404.03.b.iv (ASR 118) includes a discussion of securities valued "in good faith."

➡ *The next page is 6411.* ←

Section 6920

Voluntary Health and Welfare Organizations

.03 Basis of Valuation of Donated Materials

Inquiry—A nonprofit, church-related home for custodial care and placement of homeless children receives cash and noncash gifts daily. The gifts include such items as bread, a used pickup truck, and livestock, and other agricultural commodities grown, raised, or produced by the donor. At what value should such gifts in kind be recorded?

Reply—The AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (1974), chapter 5, deals with donated material and services. Page 20 discusses donated material as follows:

Donated materials of significant amounts should be recorded at their fair value when received, if their omission would cause the statement of support, revenue, and expenses to be misleading and if the organization has an objective, clearly measurable basis for the value, such as proceeds from resale by the organization, price lists, or market quotations (adjusted for deterioration and obsolescence), appraisals, etc. Such recording is necessary to properly account for all transactions of the organization, as well as to obtain stewardship control over all materials received.

If the nature of the materials is such that valuations cannot be substantiated, it is doubtful that they should be recorded as contributions; used clothing received as contributions and subsequently given away might, for example, fall into this category. There is, of course, no valuation problem where donated materials are converted into cash soon after receipt, since the net cash received measures the contribution.

When donated materials are used in rendering the service provided by the organization, the cost of such materials included in the service is based on the value previously recorded for the contribution. If donated materials pass through the organization to its charitable beneficiaries and the organization merely serves as an agent for the donors, the donation normally would not be recorded as a contribution.

If significant amounts are involved, the value of the materials recorded as contributions and expenditures should be clearly

disclosed in the financial statements. Free use of facilities and other assets useful in fulfilling the organization's purposes should also be recorded as contributions, based on criteria similar to those outlined above. The basis of valuation should also be disclosed.

.04 Confirmation of Pledges Receivable Necessary Audit Procedure

Inquiry—A client, a charitable organization, solicits pledges for contributions from the public. The records of the organization are kept on an accrual basis.

The client feels that the pledges receivable do not have to be confirmed. Is it a necessary audit procedure to confirm pledges receivable?

Reply—Confirmation of pledges receivable is necessary. One of the audit procedures listed in the AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (1974), on page 19 is as follows:

On a test basis, circularize pledges receivable to establish that they are bona fide and to obtain confirmation of certain information, such as possible restrictions and the period over which the pledges become due. The confirmation should be carefully worded to avoid any implication that the donor is being requested to pay the amount pledged.

.07 Allocation of Fund Raising Expenses

Inquiry—In the AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, Exhibit A indicates total plant fund expenses of \$42,000 whereas Exhibits B and C indicate total depreciation expense for the year as \$34,000. What does the \$8,000 difference represent?

Reply—The \$8,000 difference represents fund raising expenses, allocated to the Land, Building and Equipment Fund.

.08 Depreciation Accounting Adopted

Inquiry—The AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, requires the recording of depreciation. The last paragraph starting on page vi reads as follows:

Accounting adjustments that may be required to conform with the accounting and reporting procedures set forth in this

guide should be retroactively applied to prior period financial statements. The resulting effects of the prior period adjustments should be disclosed in notes to the financial statements for the year in which such adjustments are made.

When depreciation accounting which is recommended by the Guide is adopted, how should the accumulated depreciation be recognized?

Reply—The accumulated depreciation recorded as a prior period adjustment should be depreciation for the number of years that the related asset has been in service.

.09 Valuation of Real Estate Investments

Inquiry—What basis should a voluntary health and welfare organization use to record investments in real estate donated to, or purchased by, the organization?

Reply—The AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, page 5, states that a voluntary health and welfare organization should record purchased investment securities at cost and donated investment securities at their fair market value at date of gift. That basis of valuation also applies to investments in real estate.

➤➤➤→ *The next page is 6471.* ←➤➤➤

Section 6930

Employee Health and Welfare Benefit Funds

.01 Computation of Liability for Accumulated Eligibility Credits

Inquiry—An insured fund receives premiums of \$50 per month per individual. Accumulated eligibility credits 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 x 3 months x \$50	\$ 60,000
500 members x 6 months x \$50	150,000
800 members x 9 months x \$50	360,000
	<hr/>
Liability for accumulated eligibility credits	\$570,000
	<hr/>

Reply—Contributions should be set aside to provide for the full amount of the liability for accumulated eligibility credits since these insurance premiums will be paid by the fund even though no additional contributions are made to the fund on behalf of the eligible employee. The above computation is the appropriate method to use in determining the liability. Other factors, such as discounting, mortality, or terminations, could be a refinement to the computation, and would be equally acceptable.

.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* (1983), indicates in paragraphs 4.19 and 4.22 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 on the balance sheet of the fund. How should the maintenance of benefits provision be shown?

Reply—Potential benefit claims should be reflected as “estimated health claims incurred but not reported” and “estimated future benefits based on participant's accumulated eligibility” (see page 163 of the Audit and Accounting Guide). 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. [Amended]

.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 balance sheet. 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—The AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans* (1983), paragraphs 4.17 and 4.18, discusses accrued experience rating adjustments. The Audit and Accounting Guide, paragraph 4.18, 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. [Amended]

➤➤➤→ *The next page is 6521.* ←➤➤➤

Section 6935

Profit Sharing and Pension Plans

.01 Financial Statements for a Profit Sharing Plan

Inquiry—What financial statements are appropriate for a profit sharing plan? Should investments be stated at market value on the balance sheet? Is a summary of significant accounting policies required?

Reply—The financial statements for a profit sharing plan should deal with the net assets available for plan benefits and the changes in net assets available for plan benefits. The statement of net assets available for plan benefits would include, under assets, cash, contributions receivable, fund deposit with insurance company at fair value, and other assets. The liabilities would typically include accounts payable, with the balance described at “Net Assets Available for Plan Benefits.”

The statement of changes in net assets would include, as additions, contributions from employers, interest and dividend income, any fee income collected, unrealized appreciation of investments, and gains or losses on sale of securities. The deductions would typically include benefit payments related to retirement, disability, death, termination, and other benefits payable under the plan and would also include any expenses in connection with the administration of the fund. There would be no “income statement” as such.

The purpose of a profit sharing plan is to provide resources from which benefits can be paid. This fundamental distinction between the financial statements of a business enterprise and those of a profit sharing plan seems to indicate that the generally accepted accounting principle of reporting assets at cost should be changed to reflect the investments at their fair market value at the statement date, with cost disclosed parenthetically or by footnote.

APB Opinion No. 22, *Disclosure of Accounting Policies*, paragraph 8, which deals with the applicability of the disclosure of accounting policies, states that a description of all significant accounting policies of the reporting entities should be included as an integral part of the financial statements whenever the statements issued purport to fairly present financial position, changes in financial position, and the results of operations in

accordance with generally accepted accounting principles. APB Opinion No. 22 applies to both businesses and nonprofit organizations, and, since no specific exemptions are listed, it would appear necessary to disclose the accounting policies followed in the financial statements of the profit sharing plan.

.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, 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.

- (1) Should depreciation expense be reflected for this plan investment?
- (2) If the client insists on reflecting this depreciation, how should it be reported in the financial statement?

Reply—(1) No. Depreciation expense is normally an adjustment of the valuation of fixed assets reported at cost. This appears obvious in FASB Statement No. 35, paragraph 14, 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.

(2) Any historical-cost based depreciation of plan investments should be an adjustment to the net appreciation (depreciation) in fair value of investments required to be presented in the statement of changes in net assets available for benefits.

➡ 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 \$1000 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, paragraph 8, 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 paragraph 5, 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, 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]

➤➤➤➤➤ *The next page is 6601.* ➤➤➤➤➤

Section 6950

State and Local Governmental Units

.01 Financial Statements of Indian Tribe as a Governmental Entity

Inquiry—A CPA has been engaged by an Indian tribe to render an opinion on their financial statements which have previously been prepared on the assumption that the tribe was a commercial enterprise. The tribe receives numerous federal grants and administers several National Economic Development Association and Housing and Urban Development programs. Should the tribe be viewed as a governmental entity with individual fund statements presented for the various entities within the tribe, or should a single consolidated balance sheet be prepared for the tribe as a whole?

Reply—The tribe should probably be considered as a sovereign entity, presumably with a tax-exempt status, and the financial statements of the tribe should be prepared and reported as those of a local governmental unit. The commercial dealings of the tribe should be reported as enterprise funds. There should also be adequate footnote disclosure of the amounts received from the several federal agencies, and the prohibitions and limitations related to the grants and projects should be described.

.02 Balance Sheet Presentation of Outside Interest in Water Facilities

Inquiry—A government authority is currently constructing a dam and reservoir for a city. Under a previous contract executed several years earlier between these two entities, the city agreed to purchase water from the authority provided that the revenues produced were used in the eventual construction of a dam and reservoir similar to that now under construction. Amounts paid to the authority under the contract were treated as any other water sales and made their way into Accumulated Operating Revenues in the authority's accounts. Recently an adjustment was made on the authority's books reducing the Accumulated Operating Revenues by the amount of previously earned water

revenue leaving only the authority's net investment in the project remaining in its accounts. What is the proper presentation in the balance sheet of the authority of the equity held by the municipality in facilities serving both the authority and the municipality?

Reply—If the authority has legal title to the facilities, it would appear that the municipality's equity should be treated as a credit item, similar to the treatment on the books of industrial companies of minority interest, and similar to the treatment on statements of public utilities of contributions in aid construction.

Even if legal title to the facilities does not vest in the authority, it would appear that, since the authority has operating authority over the facilities, such treatment would still be acceptable. Alternatively, the equity of the municipality might be shown on the asset side of the authority's balance sheet as a deduction from the fixed assets.

.03 Effect on Auditor's Opinion of Inconsistency in Charging Operating Costs to Funds of School Districts

Inquiry—A school district follows cash basis accounting. The state school code allows operational costs to be charged either to the educational fund or the building fund. If the operational costs are included in the educational fund in one year and the building fund the next year, should the auditor qualify his report for consistency in the application of accounting principles?

Reply—Yes. The AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units*, page 152, indicates that when the governmental unit prepares its financial statements on a cash basis, SAS No. 14, *Special Reports*, paragraph 8, should be followed. The suggested opinion in SAS No. 14, paragraph 8, contains the phrase, "which basis has been applied in a manner consistent with that of the preceding year." Therefore, the auditor's report should contain a consistency exception. [Amended]

.05 Confirmation of Taxing District's Taxes Receivable

Inquiry—A client, a hospital district, is a taxing authority. The hospital district taxes are assessed and collected by the county government with the net proceeds remitted, by the

county, to the district. The county maintains all of the tax rolls and related records.

In order to render an unqualified opinion on the district's accounts, which would include the tax revenues and the taxes receivable, it would appear necessary to examine the tax rolls of the county government, including selecting properties physically and tracing them to the tax rolls, footing the tax rolls, checking mathematical accuracy of assessment, etc.

Are these procedures necessary, or would it be sufficient to merely confirm collections and receivables with the county?

Reply—According to the AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units*, page 64, confirmation of the tax revenues with the county usually would be sufficient. In addition to confirming the receivables with the county government, the auditor should consider evaluating collectibility. [Amended]

.07 Transfers Between Funds

Inquiry—A state governmental unit makes annual transfers of cash from its general fund to a recreation fund. The transfers are not required by law or bond covenants, are not related to any particular revenue source of the general fund, and are recurring depending on the financial needs of the recreation fund. What is the appropriate accounting treatment for these transfers?

Reply—Interfund transactions are discussed in the AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units*, page 62. The described transfers are similar to transactions that would be treated as revenues or expenditures were they conducted with outsiders. Therefore, the transfers should be accounted for as expenditures of the general fund and nonoperating revenue of the recreation fund. [Amended]

.08 Litigation Settlement Received in Installments

Inquiry—Defendants in a class action suit instituted several years ago by a municipality agreed to make payments to the municipality in five equal installments over the next five years. How should the municipality account for the payments to be received?

Reply—Since the terms of the settlement call for five equal installments over the next five years, one fifth of the settlement should be reported as revenue each year under the modified accrual basis of accounting and the settlement should be dis-

closed in the notes to the financial statements. The AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units*, pages 59-60, states:

The modified accrual basis of accounting should be used in governmental funds-general fund, special revenue funds, capital projects funds, debt service funds, and special assessment funds, in which most receivables, revenues, and interfund transactions are recorded. According to GASB Codification, section 1600.106, revenues should be recognized in the accounting period in which they become available and measurable under the modified accrual basis of accounting.

In that usage, the term available means collectible in the current period or soon enough thereafter to be used to pay liabilities that are owed at the balance sheet date. Measurable, of course, refers to the ability to quantify in monetary terms the amount of the revenue and receivable.

[Amended]

.09 Inadequate Property Records

Inquiry—An independent auditor, examining the Statement of General Fixed Assets of a City, was not satisfied as to the completeness or accuracy of the records for approximately 40% of the assets. Tests performed by the independent auditor indicated that the bases for those assets were not in conformity with generally accepted accounting principles. Accordingly, the independent auditor expressed an adverse opinion on the Statement of General Fixed Assets. How can acceptable asset records be established?

Reply—The first step in establishing acceptable general fixed asset records is to prepare an inventory of the assets that the City owns. If the City does not have records of individual assets, City personnel can take a physical inventory. An estimated cost may be assigned to each item in the inventory. A formal appraisal of an independent appraiser may not be required.

If the City's independent auditor is satisfied that reasonable results have been achieved in identifying all of the assets that the City owns and in estimating their original cost, he should be able to express an unqualified opinion on the Statement of General Fixed Assets. [Amended]

.10 School Cafeteria System Not Accounted for as Enterprise Fund

Inquiry—Can a school cafeteria system that receives food gratis from the U. S. Government and is subsidized by federal,

state, and local government agencies be accounted for as an Enterprise Fund?

Reply—No. The AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units*, page 98, states: “Enterprise funds are used to account for activities for which the governing body (1) intends that the costs or expenses, including depreciation, of providing goods and services are to be financed or recovered primarily through user charges or (2) has decided that the periodic determination of revenues earned, expenses incurred, and net income is desired for purposes of facilitating management control and accountability.”

A school cafeteria system that is financed by grants and donations does not conform to the criteria for an Enterprise Fund. [Amended]

.11 Combined Financial Statements for Homogeneous Operations

Inquiry—The annual report of a governmental unit presents combined financial statements for funds covering homogeneous operations. Financial statements of each individual fund are not presented. Are combined financial statements for funds covering homogeneous operations, not accompanied by financial statements of each individual fund, in accordance with generally accepted accounting principles?

Reply—Yes. If several funds cover operations which are considered homogeneous, it is acceptable to present combined financial statements for the funds without presenting the financial statements of each individual fund.

.12 Depreciation and Contributions in Aid to Construction

Inquiry—How should a municipal utility (a proprietary fund) report depreciation on assets acquired from contributions in aid to construction?

Reply—GASB Codification, Section G60.116 requires depreciation on *all* depreciable fixed assets to be included in operating expenses. However, that section permits depreciation recognized on assets acquired or constructed through grants that are externally restricted for capital acquisitions to be closed to contributed capital accounts rather than to retained earnings. [Amended]

➡ The next page is 6651. ⬅

Section 6955

Single Audit Act of 1984

.01 Entities Subject to the Act

Inquiry—Under the Act, what entities are required to be audited?

Reply—Generally, the Act requires that:

- a) Each state and local government that receives, directly or indirectly, \$100,000 or more of federal financial assistance in any fiscal year must have a single audit.
- b) Each state and local government that receives \$25,000, but less than \$100,000, has an option of a single audit conducted or complying with any audit requirements of the specific program.
- c) There are no audit requirements for those receiving less than \$25,000, but the entity must keep required records.

(The above response is consistent with an item in *The CPA Letter* dated January 28, 1985.)

.02 Scope of Audit

Inquiry—What is the scope of an audit required by the Act?

Reply—Generally, the Act provides that:

- a) Each audit shall cover the entire operations of a state or local government or, at the option of that government, it may cover departments, agencies or establishments that received, expended, or otherwise administered federal financial assistance during the year. However, if a state or local government receives over \$25,000 in general revenue-sharing funds in a fiscal year, it shall have an audit of the entire organization. A series of audits of individual departments, agencies and establishments for the same fiscal year may be considered a single audit.

- b) The audit may exclude public hospitals and public colleges and universities.
- c) The audit shall determine and report on whether:
 - 1) The financial statements of the organization present fairly its financial position and the results of its financial operations in accordance with generally accepted accounting principles and that the organization has complied with laws and regulations that may have a material effect on the financial statements;
 - 2) The organization has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations; and
 - 3) The organization has complied with laws and regulations that may have a material effect upon each major federal assistance program.

(The above response is consistent with an item in *The CPA Letter* dated January 28, 1985.)

.03 Internal Control

Inquiry—How does the Act define internal control?

Reply—“Internal control” means the plan of organization and methods and procedures adopted by management to ensure that:

- a) Resource use is consistent with laws, regulations and policies;
- b) Resources are safeguarded against waste, loss and misuse; and
- c) Reliable data are obtained, maintained and fairly disclosed in reports.

(The above response is consistent with an item in *The CPA Letter* dated January 28, 1985.)

.04 Audit Reports

Inquiry—What audit reports does the Act require?

Reply—To comply with the Act and the General Accounting Office's *Standards for Audit*, the auditor should issue the following three separate, but interrelated, reports:

- a) A report on the financial statements of the recipient of federal assistance including the supplementary schedule of federal assistance.
- b) A report on the internal controls of the recipient organization including internal controls used to manage federal financial assistance programs.
- c) Comments on the recipient organization's compliance with the terms and conditions of federal laws and regulations applicable to federal assistance programs.

(The above response is consistent with an item in *The CPA Letter* dated January 28, 1985.)

.05 Frequency of Audits

Inquiry—Under the Act, how often are audits to be conducted?

Reply—Generally, audits shall be made annually unless the state or local government has a constitutional or statutory requirement for less frequent audits.

(The above response is consistent with an item in *The CPA Letter* dated January 28, 1985.)

.06 Generally Accepted Government Auditing Standards

Inquiry—Are CPAs required to state that their examination was made in accordance with generally accepted government auditing standards?

Reply—CPAs in public practice who are covered by the AICPA's ethical standards may not state that their examination was made in accordance with generally accepted government auditing standards. General Accounting Office (GAO) *Standards*, page 28, provides that CPAs state that their examination was made in accordance with generally accepted auditing standards and GAO's *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions* with respect to financial and compliance audits.

(The above response is consistent with an item in *The CPA Letter* dated January 28, 1985.)

.07 Generally Accepted Auditing Standards

Inquiry—Do the requirements of the Act go beyond generally accepted auditing standards (GAAS)?

Reply—Yes, the Act and the General Accounting Office standards have auditing requirements that go beyond GAAS in the areas of studying and reporting on internal control systems relating to federal assistance programs and the testing and reporting on compliance with applicable laws and regulations. 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 a governmental engagement and agrees to follow specified government audit standards, guides, procedures, statutes, rules and regulations, he is obliged to follow those standards or guidelines in addition to generally accepted auditing standards. Failure to do so is an act discreditable to the profession in violation of rule 501 of the AICPA Code of Professional Ethics unless he discloses in his report that he has not followed them and the reasons therefor.

(The above response is consistent with an item in *The CPA Letter* dated January 28, 1985.)

»»»→ *The next page is 6701.* ←«««

Section 6960

Colleges and Universities

.01 Auditors' Reporting Obligations in Connection with Departures from Industry Audit Guides

Inquiry—A client is a state supported college. The state supported colleges in this state have had a uniform published accounting manual for several years which sets forth their accounts and financial statement presentation. The recent AICPA Industry Audit Guide, *Audits of Colleges and Universities* (1973), has brought forth certain financial statement changes for these state supported institutions. Many of the changes will be incorporated into their manual, however, a few areas of change which could be significant are not scheduled to be accepted for the manual at the present time.

What are the auditor's reporting obligations when a client's financial statements do not comply with the provisions of an Industry Audit Guide?

Reply—The Industry Audit Guides and Industry Accounting Guides of the AICPA contain a statement such as the following in their "Notice to Readers":

Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

As a practical matter, the auditor should indicate the departures from the Guide in a middle paragraph if he believes the departures require a qualified or adverse opinion.

.02 Valuation of Fixed Assets When Historical Records are Unavailable

Inquiry—A university does not have records of the historical costs of its fixed assets.

What method can the university use to arrive at a proper value for these assets for financial statement purposes?

Reply—Page 48 of the AICPA Industry Audit Guide, *Audits of Colleges and Universities*, states, "In the absence of historical cost records, the assets may be stated at historically based appraised values with subsequent additions at cost."

This means that the appraisals should be based on values existing at the actual or approximate dates of acquisition for

these assets and should take into account depreciation since acquisition.

.03 Mandatory Transfer of Interest on College's Construction Loans

Inquiry—The AICPA Industry Audit Guide, *Audits of Colleges and Universities* (1973), states on page 29:

Provision for Debt Service on Educational Plant. Includes mandatory debt service provisions relating to educational plant including amounts set aside for debt retirement, interest and required provisions for renewals and replacements. . . .

Does this include interest currently paid on loans from a bank to temporarily finance reconstruction of the plant?

Reply—If the loans are in the nature of construction loans being used until permanent financing for the plant is arranged, the interest paid can be treated as a mandatory transfer as discussed on page 29 and illustrated on page 67 of the guide.

.04 Direct and Indirect Costs to be Included in Educational and General Expenses and Auxiliary Enterprises

Inquiry—Is it in accordance with the AICPA Industry Audit Guide *Audits of Colleges and Universities* (1973) for various expenditures classified as “educational and general” and as “auxiliary enterprises” (as illustrated on pages 66 and 67 of the Guide) to include only direct costs, or must indirect costs be allocated to these items?

Reply—The AICPA Industry Audit Guide *Audits of Colleges and Universities* states on page 26:

Current funds expenditures and mandatory transfers comprise (1) all expenses incurred, determined in accordance with the generally accepted accrual method of accounting, except for the omission of depreciation; (2) expenditures from current funds for renewals and replacements of equipment; and (3) amounts transferred to plant funds as required for debt service, including principal, interest, and mandatory provisions for renewals and replacement of facilities.

Pages 29 and 30 contain a discussion of auxiliary enterprise expenditures and mandatory transfers and indicate:

This category of expenditures embraces all costs of operating the auxiliary enterprises, including charges for operation and maintenance of physical plant, general administration, and general institutional expenses; also included are other direct and indirect costs whether charged directly as expenditures or allocated as a proportionate share of costs of other departments or units.

Therefore, in accordance with the guide, the various expenditures classified as “educational and general” and as “auxiliary enterprises” should include both direct and indirect costs applicable to those items.

.05 Accounting for Pledges Receivable as Assets

Inquiry—A fund-raising foundation is associated with a state supported university. The foundation’s financial statements are prepared on a modified cash basis accounting system.

The foundation’s statements include pledges receivable as an asset. This is offset on the liabilities side of the balance sheet by deferred revenue. The pledges are substantiated in writing, and most of these are being paid over a ten-year period in even installments, but this is not required. Payments may be made on the pledge as the donor pleases. The foundation feels that the pledges should not be taken into revenue and fund balance until the pledges are collected. An allowance for uncollectible pledges has not been established. Do the procedures outlined adhere to generally accepted accounting principles?

Reply—The AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (1974), indicates that pledges receivable should be recorded as assets when received, with appropriate provision for uncollectibles. If the pledge will not be collected within the ensuing year, there should be appropriate discount provided in accordance with Accounting Principles Board Opinion No. 21. The Industry Audit Guide, *Audits of Colleges and Universities* (1973), states on page 8:

Pledges of gifts, including uncollected subscriptions, subscription notes, and estate notes, should be disclosed in the notes unless they are reported in the financial statements. The notes to the financial statements should disclose the gross amounts by time periods over which the pledges are to be collected and related restrictions, if any, as to use.

If the pledges are reported in the financial statements, they should be accounted for at their estimated net realizable value in the same manner as gifts received (except as to asset classification, for which pledges would be reported as a receivable), and credited to unrestricted revenues, deferred income, current restricted funds, plant funds, etc., as appropriate. The estimated net realizable value comprehends the present value of long-term pledges and reductions for any allowance for uncollectible pledges.

.06 Expenditures for Library Books

Inquiry—Chapter 6, “Current Funds Expenditures and Transfers,” of the AICPA Industry Audit Guide, *Audits of Colleges and Universities*, refers on page 28 to accounting for library books, as follows:

Libraries. Includes separately organized libraries, both general and departmental. Expenditures include the cost of books, catalogues, subscriptions, binding, and audio-visual aids as well as expenditures for personal services, supplies, and equipment.

What is the accounting for library books in financial statements on the accrual basis?

Reply—The term “expenditures” used in the Guide connotes “outlays” rather than “expenses.” Accordingly, as indicated on pages 47, 48, 63, 66, and 68 of the Guide, some expenditures for library books may be capitalized. It is standard practice to view the purchase of library books as a current fund expenditure with a debit to libraries and a credit to cash. At the same time, an entry is made in the plant fund capitalizing the library books. This treatment would apply to purchases of both new books and replacements. Page 48 of the Guide indicates that library books should be valued in the plant fund at cost or some other reasonable basis.

.07 Changes in Assumptions Related to Annuity Funds

Inquiry—The AICPA Industry Audit Guide, *Audits of Colleges and Universities*, states that the annuity liability and fund balance of annuity funds are adjusted periodically for changes in life expectancy. Are the liability and fund balance also adjusted for changes in dividend and interest rates?

Reply—All assumptions included in the computation for annuity liability should be evaluated if deviations between the assumptions and current experience are sufficiently material. Adjustments to the annuity liability and fund balance would include life expectancy and rates of dividends and interest, as well as realized and unrealized gains and losses on securities held. Basically, the liability should represent the present value at the date of the remaining annuity payments.

.09 Revenue and Expenditures for Summer Session

Inquiry—If a special academic term such as a summer session begins in one fiscal year and ends in another fiscal year, in which year or years should the revenue and expenditures for the special term be recognized?

Reply—Page 7 of the AICPA Industry Audit Guide, *Audits of Colleges and Universities*, states:

Revenues and expenditures of an academic term, such as a summer session, which is conducted over a fiscal year end, should be reported totally within the fiscal year in which the program is predominantly conducted.

In other words, if six weeks of an eleven week summer session are in fiscal year 19x1 and five weeks are in fiscal year 19x2, the summer session revenue and expenditures should be reported in fiscal year 19x1.

The exception to strict accrual basis accounting stated on page 7 of the Guide reflects the general practice of colleges and universities to account for an entire summer or special session in one or another fiscal year—the year that contains the greater portion of the program. Whether the general practice, or some other practice is adopted, the practice should be followed consistently.

.11 Accounting for Compensated Absences

Inquiry—FASB Statement 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 Colleges and University Business Officers (NACUBO) asked the FASB to defer the applicability for FASB 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 FASB 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 FASB Statement No. 43.

Practitioners have raised the following questions:

- 1) How should the charge be accounted for when the liability is first recorded?
- 2) Can a receivable and related revenue 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?
- 3) Can the effect of the charge on the unrestricted current fund balance caused by recognition of such a liability be offset in whole or in part by interfund transfers resulting in a receivable in the unrestricted current fund?

Reply—Although the audit guide was published before FASB Statement No. 43 was issued and therefore does not refer specifically to the application of the statement to those institutions, the audit guide provides guidance that can be applied to the questions.

The accounting standards executive committee discussed the above questions and made these observations to clarify the application of FASB Statement No. 43 within the guidance provided by the audit guide:

- 1) 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.
- 2) 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.
- 3) 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.

(The above response is consistent with an item in *The CPA Letter* dated September 13, 1982.)

.12 Allocation of Overhead

Inquiry—The restricted fund of a nonprofit college includes many individual programs funded from federal, state and private grants. One of the private programs was charged a \$97,000 overhead expense amount, with the credit going to revenue in another restricted 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 interdepartmental transaction which, as stated in the AICPA Industry Audit Guide, *Audits of Colleges and Universities*, page 89, “should not be reported as revenues of the service departments but rather as reductions of expenditures of such departments. . .”.

➡ *The next page is 6851.* ⬅

Section 6980

Brokers and Dealers

.01 Auditor's Report on Internal Accounting 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 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, *Audits of Brokers and Dealers in Securities*, page 147, therefore includes the SEC as a designated recipient of the report and reads as follows:

This report is intended solely for the use of management and the Securities and Exchange Commission [specify any other regulatory body] 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 use of management, the Securities and Exchange Commission 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 accounting 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. However, for those regulatory agencies that adopt the SEC's Rule 17a-5(g) criteria, they may be recipients of the letter and the distribution paragraph of the letter may be worded as follows:

This report is intended solely for the use of management, the Securities and Exchange Commission, the New York Stock Exchange, Inc. (or other designated regulatory organization) and other regulatory agencies which rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 and should not be used for any other purpose.

TIS Section 7000

SPECIALIZED ORGANIZATIONAL PROBLEMS

TABLE OF CONTENTS

Section

7100 Proprietorships

- .01 Auditor's Opinion on Balance Sheet of a Sole Proprietorship
- .02 Disclosure of Provision for Income Taxes

7200 Partnerships

- .01 Balance Sheet Presentation of Drawings in Excess of Capital Contributions
- .02 Provision for Income Taxes on Partnership Income
- .03 Provision for Deferred State Franchise Tax on Partnership Income
- [.04] Reserved
- .05 Financial Statements of a Limited Partnership
- .06 Balance Sheet Presentation of Future Capital Contributions From Limited Partners
- .07 Accounting for Syndication Costs of Limited Partnerships

7300 Not-For-Profit Organizations

- [.01] Reserved
- .02 Balance Sheet Presentation of Rental Houses with Purchase Options
- [.03] Reserved
- [.04] Reserved
- .05 Accounting for Nonprofit Company's Investments in Securities of Subsidiaries [Amended]
- .06 Valuation of Marketable Securities Held by Trustee for Life Beneficiaries
- .07 Valuation of Contributed Services to Tax-Exempt Organizations [Amended]
- .08 Income Statement Presentation of Grants-in-Aid
- .09 Exclusion from Revenue of Designated Gifts Accepted as Custodian
- [.10] Reserved
- [.11] Reserved
- .12 Inventory Valuation for a Nonprofit Scientific Corporation [Amended]
- .13 Retention of Life Estate by Donor of Property
- .14 Valuation of Assets Purchased at Nominal Prices
- .15 Accounting for CETA Grants [Amended]
- .16 Gifts of Life Insurance Policies
- .17 Authority of AICPA SOP 78-10 [Amended]

Section

7400 Related Parties

- [.01] Reserved
- [.02] Reserved
- [.03] Reserved
- .04 Disclosure of Salary Paid to Owner-Manager [Amended]
- .05 Loans to Bank Officers and Directors [Amended]
- .06 Exchange of Interest Bearing Note for Non-Interest Bearing Note

7500 Estates and Trusts

- .01 Trust Funds for Perpetual Care of Cemetery

7600 Business Combinations—General

- .01 Date of Acquisition of a Company
- .02 Date of Consummation of a Business Combination
- .03 Financial Statement Presentation of Agreement to Acquire Company
- .04 Conditions for Pooling of Interests Method
- .05 Accounting for Acquisition Costs Incurred in Merger
- .06 Exchange of Stock Involving Companies Under Common Control
- .07 Incorporation of a Sole Proprietor
- .08 Transfers to Entities Under Common Control

7610 Purchase Method

- .01 Acquisition of Parent Company by Subsidiary
- .02 Income of Acquired Company Pending Approval of Merger by Regulatory Agency
- [.03] Reserved
- [.04] Reserved
- [.05] Reserved
- .06 Purchase of Corporation with Negative Net Worth—II
- .07 Acquisition of a Company for Price Less Than Value of Assets
- .08 Allocation of Purchase Price to Assets
- .09 Allocation of Purchase Price to Assets Purchased in Bulk [Amended]
- .10 Asset Values Stated in Purchase Agreement
- [.11] Reserved
- .12 Assignment of Asset Values Reflecting Tax Consequences of the Acquisition
- .13 Examples of Noncurrent Assets
- .14 Value of Receivables Purchased Decreased at Closing Date
- .15 Leasehold Improvements Acquired as Part of Purchased Assets
- .16 Amortization of Cost of Long-Term Land Leases Acquired
- [.17] Reserved
- .18 Acquisition of Minority Interest in Subsidiary by Either the Parent or Subsidiary Company
- .19 Step Up in Basis of a Company's Assets as a Result of a Change in Its Ownership

Section**7620 Applicability of Pooling of Interests Method**

- .01 Combination of Indirectly Owned Companies
- [.02] Reserved
- .03 Affiliate Acquiring Interest in Company Wholly Owned by Parent
- .04 Combination of Related Companies—I
- .05 Combination of Related Companies—II
- .06 Combination of Related Companies—III
- .07 Combination of Related Companies—IV
- .08 Acquisition of a Division of Another Company
- .09 Pooling of Interest Following Abandonment of Previous Attempt to Merge
- .10 Business Combination Following a "Spin-off"
- .11 Pooling of Interest Following Acquisition of Treasury Stock
- .12 Exchange of Shares Between Companies Under Common Control
- .13 Effect on Pooling of Interests of Contingently Issued Shares Held in Escrow
- .14 Issuance of Stock for Contingent Earnings Rights of Acquired Company's Stockholders
- .15 Pooling of Interests Precluded by Agreement to Redeem Stock
- .16 Purchase of Treasury Stock Between Date of Initiation and Consummation of Business Combination
- [.17] Reserved

7630 Application of Pooling of Interests Method

- .01 Individual Status of a Corporation in a Pooling of Interests
- .02 Exchange of Stock on a Share for Share Basis with Different Stated Values

7900 Other Specialized Organizational Problems

- .01 Difference Between Assets and Liabilities on Divisional Financial Statements

7910 S Corporations

- .01 Withdrawals in Excess of Accumulated Retained Earnings
- [.02] Reserved
- .03 Disclosure of Retained Earnings Components [Amended]
- .04 Reversal of Timing Difference After Termination of an Election as an S Corporation [Amended]
- .05 Reversal of Deferred Income Tax Liabilities After Company Elects S Corporation Status

*Section***7920 Domestic International Sales Corporations**

**.01 Accounting for a Domestic International Sales Corporation
Subsidiary**

[.02] Reserved

.03 Sales to Domestic Companies Classified as Export Sales

➡ The next page is 7021. ←

Section 7100

Proprietorships

.01 Auditor's Opinion on Balance Sheet of a Sole Proprietorship

Inquiry—It is often doubtful that a sole proprietor can actually separate his business assets and liabilities from his personal assets and liabilities. Under the circumstances, how can a CPA possibly give an unqualified opinion on the balance sheet of a sole proprietorship?

Reply—If such conditions exist, an auditor obviously could not form an opinion as to fair presentation of the financial position of the proprietorship taken alone.

However, in many instances, operations of a sole proprietorship are maintained on a separate basis, and the financial records of the proprietorship are maintained with sufficient internal accounting control to allow an auditor to form his opinion. In such instances, the fact that the assets of the proprietorship are available to meet personal liabilities of the proprietor would not necessarily preclude forming an opinion as to fair presentation of the assets and liabilities of the proprietorship. Any indication that assets of the proprietorship are in fact to be withdrawn to meet personal obligations of the proprietor should of course be disclosed.

.02 Disclosure of Provision for Income Taxes

Inquiry—Are financial statements for a proprietorship required to show an income tax provision?

Reply—There is no requirement that an income tax provision be reflected in the financial statements of a proprietorship since the proprietor's total income tax is affected by other matters not related to the business.

»»»→ *The next page is 7071.* ←«««

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.

.03 Provision for Deferred State Franchise Tax on Partnership Income

Inquiry—Being a partnership, a firm is not liable for federal income taxes; however, the company must pay a state franchise tax which is based on income. As with income taxes, there are several factors that will result in differences between taxable income and book income. Must there be a provision for deferred state franchise tax on the financial statements?

Reply—APB Opinion No. 11, paragraph 13(a), defines income taxes as used in the Opinion to include “foreign, state and other taxes (including franchise taxes) based on income.” Therefore, deferred tax accounting would be necessary for any material amount of franchise tax on a difference in income that is a “timing difference” as defined in APB Opinion No. 11.

.05 Financial Statements of a Limited Partnership

Inquiry—An auditor renders an opinion on the financial statements of a limited partnership. Should the financial statements of the limited partnership and the audit report thereon include, within the same report cover, the financial statements of and audit report on the general corporate partner?

Reply—Since the reporting entity on which the auditor is issuing an opinion is the limited partnership, it is not necessary to include the financial statements of and audit report on the general corporate partner. However, the limited partnership financial statements should disclose that it is a limited partnership.

.06 Balance Sheet Presentation of Future Capital Contributions From Limited Partners

Inquiry—Should future capital contributions, evidenced by nonnegotiable promissory notes, from limited partners be classified as an asset or as a reduction of partners’ capital on the partnership balance sheet?

Reply—No authoritative literature deals with this problem. An analogous situation is that of stock subscriptions receivable.

APB Opinion No. 25, *Accounting for Stock Issued to Employees*, paragraph 8, note 2, indicates the fact that stock subscriptions receivable may in substance be the same as the grant of a stock option and should therefore be recorded as a reduction of stockholders' equity.

Similarly, reduction of partners' capital would be acceptable accounting for future capital contributions.

.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.

➤➤➤ *The next page is 7171.* ➤➤➤

Section 7300

Not-For-Profit Organizations

.02 Balance Sheet Presentation of Rental Houses with Purchase Options

Inquiry—A nonprofit organization provides housing to members of minority groups in areas predominantly occupied by majority groups. The organization sometimes arranges outside financing for the prospective occupant and grants second mortgages to facilitate the purchase. When it is difficult or impossible to arrange adequate primary financing for a prospective occupant, the organization purchases the residence and rents it to the occupant granting him an option to purchase at the organization's cost plus any major repairs made or capitalized expenses and an amount to cover the costs of acquisition. These options run for various lengths of time and, in some cases, may be exercisable indefinitely. The association does not record depreciation on its books and considers the houses as an inventory item to which it holds title only until proper financing can be obtained by the occupants. Past experience indicates that the houses are sold for an amount equal to, or in excess of, cost and that the trend of real estate prices in the general area is upward.

Is it appropriate for the organization to omit depreciation on these houses and to carry them as inventory items in current assets? Should the balance sheet show only the net equity as an asset (the cost reduced by the first mortgage balance) or show the total cost as an asset and the mortgage debt divided between current and noncurrent liabilities?

Reply—For houses owned by the organization only until proper financing can be obtained by the occupants, it is appropriate for the organization to omit depreciation and to show them as an inventory item in current assets. However, with regard to the situation where it is difficult or impossible to arrange adequate primary financing for a prospective occupant and where the client purchases the residence and rents it to the occupant with a purchase option, this residence should be carried as a fixed asset on the balance sheet with a corresponding mortgage obligation, if any, shown on the liability side of the balance sheet. This

residence should be depreciated over its expected useful life. When and if the tenant purchases the residence, the asset would be removed from the fixed asset category and a gain or loss recorded upon disposition. The mortgage payable should, of course, be divided between current and noncurrent liabilities.

.05 Accounting for Nonprofit Company's Investments in Securities of Subsidiaries

Inquiry—A client, a state farm bureau which is a nonprofit organization, owns capital stock in two corporations. The farm bureau owns 100% of the outstanding capital stock of a corporation which sells equipment parts to farm bureau dealers. The bureau also owns 100% of the preferred stock of a grain marketing concern, while farm bureau members own 100% of the common stock.

The farm bureau has not consolidated the subsidiaries in its financial statements because it is felt the operations of the companies are incompatible for consolidation. Should the investments, however, be accounted for by the equity method?

Reply—APB Opinion No. 18, paragraph 2(b) indicates that the Opinion does not apply to investments in common stock held by nonbusiness entities. Ownership of voting preferred stock is used to test for the 20% ownership under paragraph 17, but the equity method is applied to investments in common stock. Accounting for the bureau's investment in the equipment parts corporation by the equity method may be desirable but not required. The equity method should not be used for the preferred stock investment; it should be carried at either fair value or lower of cost or fair value. [Amended]

.06 Valuation of Marketable Securities Held by Trustee for Life Beneficiaries

Inquiry—A charitable society was bequeathed various marketable securities. The terms of the trust require the net income to be paid to the life beneficiaries, and upon the death of the last survivor, the securities will become the property of the charitable society. What value should be used for the securities when they are received by the charitable organization?

Reply—When legal title to the securities devolves to the charitable society, the society should record the securities in the same manner as a nonprofit organization ordinarily records a current gift, donation or bequest. Generally accepted accounting principles support the use of fair market value at the date of the society's succession to legal title.

.07 Valuation of Contributed Services to Tax-Exempt Organizations

Inquiry—How should tax-exempt organizations treat contributed services such as those of unpaid corporate directors or other services?

Reply—The AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, pages 21-22, and SOP No. 78-10, paragraphs 67-70, specifically deal with services donated to tax-exempt organizations. Both the Audit Guide and SOP No. 78-10 indicate that a recipient organization should not record a value for donated services unless specific circumstances exist. Notes to the financial statements of the recipient organization should disclose the donated services that have been recorded and those that have not. The methods used to value, record, and report donated services should be disclosed. [Amended]

.08 Income Statement Presentation of Grants-In-Aid

Inquiry—Should grants-in-aid for operating expenses of a nonprofit organization be set up on the income statement net of the expenses or gross of expenses?

Reply—Unrestricted grants-in-aid should be shown gross on the income statement and properly designated.

.09 Exclusion from Revenue of Designated Gifts Accepted as Custodian

Inquiry—A nonprofit voluntary welfare organization's principal program activity is to subsidize other institutions for the support of children in their care. Revenues of the organization are derived mainly from contributions from the public in response to radio, television and magazine appeals. Approximately 80 percent of total revenues are received from sponsors who agree to sponsor a child in one of the institutions being subsidized by the organization. In consideration for the voluntary

acceptance of a sponsorship obligation by a donor, one of the subsidized institutions is authorized to accept the care of a child from a waiting list carried by the institution. The cost to the donor for becoming a sponsor is the payment of a specified amount per month to the organization.

As a part of its effort in fostering a personal relationship between sponsor and child, the sponsor is encouraged to send cash through the organization from time to time for delivery to the child or for the purchase, by the institution superintendent, of a personal gift from the sponsor to the child on such occasions as Christmas, birthdays, etc. The organization transmits these personal "designated gifts" from the sponsor to the child as a custodial function, without any deduction for handling or administrative costs.

Are such designated gifts received from sponsors for delivery to a specified child includible in revenue of the organization, or are such designated gifts to be excluded from revenue and treated instead as funds accepted in a custodial capacity?

Reply—The designated gifts received from sponsors should be excluded from revenue and treated as funds accepted in a custodial capacity only. The agency having custodial funds should recognize this accountability for them by including them in its balance sheet as an entirely separate fund group.

The AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (1974), page 3, contains an explanation of custodian funds.

.12 Inventory Valuation for a Nonprofit Scientific Corporation

Inquiry—Products produced by a nonprofit scientific corporation are sold at prices which are less than production costs. The difference between cost and sale proceeds is covered by grants. The corporation's balance sheet shows inventories valued at an arbitrary amount with a notation that such amount is not to indicate true value but to indicate the existence of inventories. A portion of inventories is considered as base stock and is classified as a fixed asset. No provision is made for distribution,

handling, or storage costs. For the above described situation, what is the proper method of pricing inventories?

Reply—Statement No. 5 of Accounting Research Bulletin No. 43, Chapter 4 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 entire amount of inventory, including the base stock, should be shown as inventory, not as fixed assets. Under Statement No. 6 of ARB No. 43, Chapter 4, the distribution and handling costs can be considered as “reasonably predictable costs of completion and disposal” and should be deducted from the sales price to arrive at net realizable value. The storage costs should be accounted for as period costs. [Amended]

.13 Retention of Life Estate By Donor of Property

Inquiry—A parcel of property is donated to a nonprofit educational foundation with the donor retaining a life estate in the property. When should the gift be recorded? Should the gift be recorded at current market value or at discounted estimated value of the life estate? What disclosure of the gift should be made in the financial statements of the foundation? Should the life estate be recorded as a liability?

Reply—Since the AICPA Audit Guide, *Audits of Colleges and Universities*, applies to this situation, the transfer of the parcel of property should be recorded at its fair market value as of the date of the gift in accordance with the discussion on page 8 of the guide. The term of the gift, particularly that the donor retains a life estate in the property should be disclosed. The life estate should not be reported as a liability.

.14 Valuation of Assets Purchased at Nominal Prices

Inquiry—A nonprofit organization has the right to purchase government surplus equipment at nominal prices. The organiza-

tion purchased a radio station tower antenna for \$1 paid to the Federal Government plus \$200 paid to a State Government to handle the paper work, etc. The fair market value of the asset approximates \$10,000. The organization is not allowed to sell the asset until after four years have elapsed. Can the organization record the asset at its fair market value?

Reply—Since there appears to be donative aspects to the purchased asset, the asset should be recorded at fair market value when purchased, and the donation recognized. The transaction should be adequately disclosed, including the restriction regarding sale of the asset.

.15 Accounting for CETA Grants

Inquiry—The federal government reimburses a nonprofit entity for salaries, employee benefits, and certain administrative costs paid to or on behalf of programs carried on and employees hired under CETA grants. How should the nonprofit entity report the CETA reimbursements in the statement of revenue and expenditures?

Reply—The reimbursement of expenditures and grants should be reported as a separate component of revenue. [Amended]

.16 Gifts of Life Insurance Policies

Inquiry—Should a nonprofit organization record a gift of a life insurance policy at the cash surrender value or face amount?

Reply—A nonprofit organization should record gifts of insurance at the cash surrender value, if any.

.17 Authority of AICPA SOP 78-10

Inquiry—What is the authority of SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*?

Reply—The introduction to SOP 78-10 states that SOP's do not establish standards enforceable under the Institute's code of professional ethics, but are intended to be considered, as deemed appropriate, by bodies having authority to issue pro-

nouncements on the subject. The AICPA Audit and Accounting Guide entitled *Audits of Certain Nonprofit Organizations* contains the following discussion of SOP 78-10:

On December 31, 1978, the AICPA issued Statement of Position (SOP) 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*. At that time, the Financial Accounting Standards Board (FASB) was studying the objectives of financial reporting by nonbusiness organizations. Thus, no effective date was established for adoption of the accounting principles recommended in SOP 78-10. In September 1979 the FASB issued Statement of Financial Accounting Standards no. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*, which specified that the specialized accounting and reporting principles and practices in the SOP are preferable accounting principles for purposes of justifying a change in accounting principles as required by APB Opinion no. 20, *Accounting Changes*. In December 1980 the FASB issued Statement of Financial Accounting Concepts no. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, which establishes the objectives of general-purpose external financial reporting by nonprofit ("nonbusiness") organizations. However, the FASB is continuing to study accounting standards for nonprofit organizations, and no effective date has been established for SOP 78-10.

In addition, SAS No. 5, paragraph 7 (as amended by SAS No. 43) states that AICPA Statements of Position and AICPA Industry Audit and Accounting Guides are sources of established accounting principles that the auditor should consider if accounting treatment is not specified in a more authoritative pronouncement.

SOPs present the conclusions of a majority of the Accounting Standards Executive Committee, which is the senior technical committee of the AICPA authorized to speak for the AICPA on financial accounting and reporting and cost accounting. Unless the auditor can justify a conclusion that another accounting treatment is generally accepted, an auditor's opinion on the financial statements of an entity that does not follow the recommendations in SOP 78-10 should normally be qualified. The auditor should encourage his client to follow SOP 78-10 since it represents the best thinking of the profession at this time. [Amended]

➡ The next page is 7351. ⬅

Section 7400

Related Parties

.04 Disclosure of Salary Paid to Owner-Manager

Inquiry—Does FASB Statement No. 57 require disclosure of the salary paid to an individual who is both a member of management and a principal stockholder?

Reply—FASB Statement No. 57, paragraph 2 explicitly excludes “compensation arrangements.”

The exclusion in paragraph 2 applies when an individual is an owner-manager. Therefore, the salary paid to the owner-manager does not have to be disclosed under FASB Statement No. 57. [Amended]

.05 Loans to Bank Officers and Directors

Inquiry—A bank makes loans to its officers and directors. Does FASB Statement No. 57 require the bank to disclose the loans?

Reply—The fact that a bank’s business is to make loans does not change the disclosure requirements of FASB Statement No. 57.

A bank should disclose loans to officers, directors, and employees when these loans are material individually or in total. [Amended]

.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.

➤➤➤ *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.

➡ *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:

<u>Company A</u>	
Assets	\$500,000
Liabilities	\$100,000
Common stock, no par value, 200 shares authorized and issued	100,000
Retained earnings	300,000
Total	\$500,000
<u>Company B</u>	
Assets	\$ 50,000
Liabilities	\$ 20,000
Common stock, no par value, 1,000 shares authorized, 100 shares issued and outstanding	20,000
Retained earnings	10,000
Total	\$ 50,000

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).”

.07 Incorporation of a Sole Proprietor

Inquiry—Mr. Jones, trading as a sole proprietor, decided to incorporate his business. The transfer of his net assets to the corporation in exchange for its common stock was considered a tax free exchange under a certain section of the Internal Revenue Code. The tax free exchange requires that the corporation record its assets at the cost to the transferor. Would this be in accordance with generally accepted accounting principles?

Reply—Yes. AICPA Interpretation No. 39 of APB Opinion No. 16, “Transfers and Exchanges Between Companies Under Common Control,” covers transfers and exchanges between companies under common control, such as the transfer described

above which is not covered by APB Opinion No. 16, *Business Combinations*, and merely involve a change in legal organization but not a change in the entity. The Interpretation states that the assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting.

.08 Transfers to Entities Under Common Control

Inquiry—How should a capital contribution from an individual to a 100% owned corporation be recorded?

Reply—The transfer should be accounted for at the historical cost to the individual since the transfer lacks economic substance. AICPA Interpretation No. 39 of APB Opinion No. 16, “Transfers and Exchanges Between Companies Under Common Control,” provides support for this view. Even though the transaction does not involve a business combination, the analogy is made that because the owner owns 100% of the company, the assets and liabilities so transferred would be accounted for at historical cost.

However, practice regarding this matter varies and some accountants believe this type of transfer may also be recorded at fair value. Those holding this view cite APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, paragraph 182. FASB Concepts Statement No. 6, *Elements of Financial Statements*, states 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.” Holders of this view also cite FASB Statement No. 57, *Related Party Transactions*, paragraph 3, which states that transactions with related parties should not imply that the terms of the transactions are the same as prevail in arm’s-length transactions unless such a view can be substantiated. This statement implies that a transfer to a corporation from its sole shareholder can be recorded at fair market value if the value can be objectively supported.

➡ The next page is 7531. ⬅

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, 1975, 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, 1975. 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, 1975, 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—II

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*.

.07 Acquisition of Company for Price Less Than Value of Assets

Inquiry—An investment company wished to divest itself of a subsidiary and agreed to sell the company to the subsidiary's manager. The purchase price is substantially below the carrying value of the company's assets. How should the assets be valued by the purchaser?

Reply—The amounts assigned to the assets acquired and liabilities assumed should not be the same as the carrying value of those items on the company's books. Values should be assigned to the assets acquired and liabilities assumed as discussed in paragraphs 87-89 of Accounting Principles Board Opinion No. 16. As indicated in paragraphs 87 and 91 of the Opinion, the amounts assigned to noncurrent assets (except long-term investments in marketable securities) should be reduced by a proportionate part of the excess to determine the assigned values. So-called "negative goodwill" should not be recorded unless the

noncurrent assets are first reduced to zero value. Any remaining deferred credit (remainder of the excess of acquired net assets over cost) should be systematically amortized to income over the period estimated to be benefited. The amortization period should not exceed forty years.

.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 sched-

ules 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 and 88 of Accounting Principles Board Opinion No. 16 despite the agreement?

Reply—For purposes of recording the business combination, the provisions of paragraphs 87 and 88 of APB Opinion No. 16 should be followed and cannot be circumvented by the purchase agreement.

.12 Assignment of Asset Values Reflecting Tax Consequences of the Acquisition

Inquiry—A client purchased the stock of another company and immediately liquidated the company to get an increased tax basis for the assets. As a consequence of this transaction, taxes are expected to be reduced by \$250,000 over the next ten years, but the client must currently pay \$50,000 because of depreciation recapture on the revaluation.

Is the additional tax currently payable an added cost of acquisition, or should it be charged currently as income tax expense?

Reply—Paragraph 89 of Accounting Principles Board Opinion No. 16 discusses the tax effects of assigning asset values in an acquisition. Basically, the paragraph says that the amounts assigned to the assets in the acquisition should reflect the tax consequences of the acquisition. It seems that the additional taxes paid because of the recapture rules would be one of the factors which should be considered in assigning amounts to the assets acquired.

.13 Examples of Noncurrent Assets

Inquiry—A corporation acquired the assets and assumed the liabilities of another company for consideration less than the fair value of the net assets. Paragraph 87 of Accounting Principles Board Opinion No. 16 reads in part, “. . . the values otherwise assignable to noncurrent assets acquired (except long-term in-

vestments in marketable securities) should be reduced by a proportionate part of the excess to determine the assigned values.”

Are noncurrent prepaid expenses considered “noncurrent assets” for purposes of this paragraph? What are examples of “noncurrent assets” other than plant, equipment and real property?

➤ *The next page is 7539.* ➤

Reply—Noncurrent assets, other than plant, equipment and real properties, may include investments and securities that are not marketable, long-term receivables, patents and other identifiable intangible assets, leased tangible assets, etc.

.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.

.15 Leasehold Improvements Acquired as Part of Purchased Assets

Inquiry—A corporation purchased the assets of a business. The contract states that the buyer is acquiring inventory, furniture and fixtures, and leasehold improvements. The seller established prices for these assets, and the excess paid was charged to goodwill. The contract stated that the sale was contingent upon the seller being able to terminate his lease and the buyer acquiring a new lease. A new ten-year lease was obtained by the buyer.

How should the leasehold improvements be recorded on the books of the purchaser?

Reply—Accounting Principles Board Opinion No. 16, paragraphs 67-68 and 88 discuss this topic. Paragraph 67 contains the general principles for ascertaining the cost of the group of assets. Paragraph 68 indicates that the cost of individual assets should be a portion of the total cost, based on their fair values. Para-

graph 88 provides some specific guidelines for determining assigned values.

The leasehold improvements should be assigned an amount following the suggestions in paragraph 88(d) on plant and equipment. Generally, this would be the current replacement cost.

.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.

.18 Acquisition of Minority Interest in Subsidiary by Either the Parent or Subsidiary Company

Inquiry—P company owns 80% of S company. How should the acquisition of the 20% minority interest by either P or S be accounted for?

Reply—Interpretation No. 26 of APB Opinion No. 16, *Accounting for Business Combinations*, "Acquisition of Minority Interest," states in part:

Paragraph 5 of APB Opinion No. 16 states, "The acquisition of some or all of the stock held by minority shareholders of a subsidiary is not a business combination, but paragraph 43 of this Opinion specifies the applicable method of accounting."

Paragraph 43 [of the Opinion] 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. . . . (Emphasis added.)

Therefore, the purchase method should be used to account for the acquisition of the subsidiary's minority interest by either P or S. If there is goodwill, it should be amortized in accordance with the provisions of APB Opinion No. 17, *Intangible Assets*. Any excess of acquired net assets over cost should be accounted for in accordance with APB Opinion No. 16, *Business Combinations*, paragraph 91.

.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% 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.

➡ *The next page is 7681.* ←

Section 7620***Applicability of Pooling of Interests Method*****.01 Combination of Indirectly Owned Companies**

Inquiry—At October 31, 1970, Company A owned less than 70 percent of Company B, and Company B owned less than 70 percent of Company C. The three companies later combined with neither the stockholders of Company A nor the minority stockholders of B or C receiving in excess of 50 percent of the stock issued. Could such a transaction be accounted for as a pooling of interest under the provisions of paragraph 99 of Accounting Principles Board Opinion No. 16?

Reply—Paragraph 99 of APB Opinion No. 16 states in part:

If a corporation holds as an investment on October 31, 1970 a minority interest in or exactly 50 percent of the common stock of another company and the corporation initiates after October 31, 1970 a plan of combination with that company, the resulting business combination may be accounted for the pooling of interests method provided . . .

As the stockholdings of the combining companies in each case exceed 50 percent, this exception does not apply.

.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 Accounting Principles

Board 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 Accounting Principles Board 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 to 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 Accounting Principles Board 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 to 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 in-

volve 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 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 Accounting Principles Board 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 equity. 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 Accounting Principles Board 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 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. Accounting Principles Board 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 Accounting Principles Board 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 Accounting Principles Board 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 Accounting Principles Board Opinion No. 16?

Reply—Paragraph 46a of APB Opinion No. 16 states that to qualify for a pooling of interest, "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."

Paragraph 47c 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 paragraphs 46a and 47c of Accounting Principles Board Opinion No. 16, the transaction must be considered a "purchase."

.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 to Accounting Principles Board Opinion No. 16, will the company be precluded from entering pooling of interest business combinations 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 re-acquiring 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 Accounting Principles Board 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 representations” as referred to in Interpretation 30 to Accounting Principles Board 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 to APB Option 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 47-g 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 Accounting Principles Board 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 paragraphs 48a and 48b of the Opinion 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.

.16 Purchase of Treasury Stock Between Date of Initiation and Consummation of Business Combination

Inquiry—In connection with its initial public offering more than one year ago, a company issued to the underwriters five-year warrants to purchase voting common shares at the same price the shares were issued to the public. The company wishes to purchase now, or from time to time as it deems prudent, the aggregate number of common shares for which warrants are outstanding. The company intends to specifically reserve those shares in its treasury for such purpose and to reissue them for the warrants exercised. Would such repurchases of voting common stock for the treasury between the date of initiation and consummation of a business combination destroy what would otherwise have been a transaction accounted for by the pooling of interests method?

Reply—Paragraph 47d of Accounting Principles Board Opinion No. 16 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." Interpretation No. 20 to APB Opinion No. 16 states in part:

The statement "for purposes other than business combinations" means combinations initiated under APB Opinion No. 16 which are to be accounted for by the pooling of interests method. Therefore, acquisitions of treasury stock for specific purposes that are not related to a particular business combination which is planned to be accounted for by the pooling of interests method are not prohibited by the conditions of either paragraph 47-c or 47-d.

In the absence of persuasive evidence to the contrary, however, it should be presumed that all acquisitions of treasury stock during the

two years preceding initiation and consummation were made in contemplation of effecting business combinations to be accounted for as a pooling of interests. . . . Treasury shares reacquired for these purposes should be either reissued prior to consummation or specifically reserved for those purposes existing at consummation.

In this case the company is reacquiring the shares for the specific purpose of meeting its commitments in connection with the warrants issued to the underwriters and intends to reserve the treasury shares so acquired specifically for reissuance in connection with those warrants. Therefore, taking paragraph 47d and the interpretation together, acquisition of voting common stock to be reserved and used for the purpose of satisfying the client's commitments in connection with the warrants issued to the underwriters would constitute the acquisition of treasury stock "for purposes other than business combinations" and would not preclude the use of pooling of interests accounting for a pending business combination which otherwise meets all of the conditions specified in APB Opinion No. 16.

➡ *The next page is 7831.* ←

Section 7630

Application of Pooling of Interests Method

.01 Individual Status of a Corporation in a Pooling of Interests

Inquiry—Accounting Principles Board Opinion No. 16 states in paragraph 47:

A transfer of net assets of a combining company to effect a business combination satisfies condition 47-b provided all net assets of the company at the date the plan is consummated are transferred in exchange for stock of the issuing corporation.

If net assets are transferred in exchange for stock, what happens to retained earnings of the combining corporation? Does that corporation retain its individual status as a separate corporation with its primary asset being the stock received for the net assets transferred?

Reply—This part of paragraph 47 of APB Opinion No. 16 is directed toward accounting for a business combination in which one company transfers its net assets to another or in which each company transfers its net assets to a newly formed corporation, and which is treated as a pooling of interests.

Where this occurs, the accounting for the company resulting from the combination should be the same as though stock had been transferred—that is, the retained earnings of each of the companies should be included as retained earnings of the combined company, except to the extent that higher par value of the stock issued may result in capitalizing retained earnings.

Opinion No. 16 is directed toward accounting for the combination, rather than for the individual companies being combined. However, if the stock received by a combining company for its assets was not distributed pro rata to its shareholders, the provisions of paragraph 47e, of the Opinion would not be met, and the combination could not be accounted for as a pooling of interests.

.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.

➤➤➤→ *The next page is 7951.* ←➤➤➤

Section 7900

Other Specialized Organizational Problems

.01 Difference Between Assets and Liabilities on Divisional Financial Statements

Inquiry—The financial statements of a division do not include an equity section. How should the difference between assets and liabilities be reported in the financial statements?

Reply—The division of a company could be considered a “branch office.” The difference between the assets and liabilities could be considered a “home office” account. If management is interested in knowing the division’s accumulated profits and losses then a detailed analysis of this account will have to be maintained by the accounting department so the information might be disclosed in the footnotes or on the face of the balance sheet. Another alternative is to present a statement of net assets instead of a balance sheet.

➤➤➤ *The next page is 7981.* ➤➤➤

Section 7910

S Corporations

.01 Withdrawals in Excess of Accumulated Retained Earnings

Inquiry—In the first year of operations, the shareholders of a company withdrew considerable sums in anticipation of profits, but the company incurred a small net loss. Following this first year, the company has elected S Corporation status, and it is likely that the shareholders will withdraw current income each year.

Should the first year deficit be shown as a deficit in retained earnings or as a reduction of capital? If the shareholders do not withdraw all the profits, may the deficit be offset against retained earnings?

Reply—Under the corporation laws of many states, corporations may not make distributions to stockholders except from “available surplus.” Therefore, the company should obtain appropriate legal advice as to the effect of the withdrawals referred to, and the effect of future withdrawals in excess of accumulated retained earnings. If the withdrawals are legal, it would appear that they should be charged to capital, rather than to retained earnings. If future distributions may be made in excess of accumulated retained earnings, it would appear that the excess distribution should be from capital and described as such.

If accumulated retained earnings, not distributed, include earnings which have been taxed to the stockholders, it would appear necessary for fair disclosure to indicate the amount of retained earnings on which such taxes have been paid.

.03 Disclosure of Retained Earnings Components

Inquiry—Is it acceptable for an S Corporation to show a single balance sheet caption and amount for retained earnings?

Reply—An S Corporation should show a single balance sheet caption and amount. The components of retained earnings (pre-election accumulations, shareholders’ undistributed taxable income previously taxed, accumulated adjustment account and

other adjustment accounts) may be disclosed in the notes to the financial statements or supplementary information if it is meaningful to users of these financial statements. [Amended]

.04 Reversal of Timing Difference After Termination of an Election as an S Corporation

Inquiry—As an S Corporation not subject to federal income taxes, Company A did not provide deferrals for the tax effects of timing differences. Subsequently, Company A terminated its S Corporation election. Should the deferred income taxes attributable to the timing differences be reinstated? If so, at what rate? Should it impact the beginning retained earnings?

Reply—There is no authoritative literature on this particular subject. Some accountants believe that the appropriate deferred income taxes should be reinstated at the rate that was in effect when the timing difference originated. The cumulative effect of this reinstatement would be reported in the current year's statement of income, as part of the income tax provision, with appropriate disclosure. Accordingly, the reinstatement would not impact the beginning retained earnings. Any timing differences for the current year (termination of election) and thereafter would be reported in accordance with APB Opinion No. 11, *Accounting for Income Taxes*.

Other accountants believe that reinstatement of deferred income taxes should not be reported as of the termination of the S Corporation election and only timing differences in the year of termination and thereafter should be recorded. Those who advocate this position would consider timing differences originating while the S Corporation election was in effect and reversing when the election was terminated as permanent differences. [Amended]

.05 Reversal of Deferred Income Tax Liabilities After Company Elects S Corporation Status

Inquiry—A regular corporation with substantial deferred income tax liabilities reported in its financial statements has elected to be taxed as an S Corporation effective in its next year. Since an S Corporation is not subject to federal income taxes, how should the deferred income tax liabilities be accounted for?

Reply—There is no authoritative literature on this particular subject. Some accountants believe that the entire balance of the deferred income tax liabilities should be reversed, in the first

year of the S Corporation, and be reported in the income statement with appropriate footnote disclosure. Appropriate disclosure in the current year's financial statements would notify the user of these financial statements that the deferred income tax liabilities will be reversed in the subsequent year.

➤ *The next page is 8011.* ➤

Section 7920

Domestic International Sales Corporations

.01 Accounting for a Domestic International Sales Corporation Subsidiary

Inquiry—In a Domestic International Sales Corporation (DISC), one half of the earnings are required to be distributed back to the parent company, but the remaining one half may be retained by the subsidiary untaxed. How should the income of a DISC subsidiary be reported in the parent's financial statements under the equity method of accounting for subsidiaries?

Reply—A DISC subsidiary should be accounted for in the same manner as any other subsidiary. Paragraph 19(c) of Accounting Principles Board Opinion No. 18 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 an investee(s) should ordinarily be shown in the income statement as a single amount except for the extraordinary items as specified in (d) below.

A caption commonly used is "equity in earnings of unconsolidated subsidiaries." If the subsidiary has items of extraordinary income or expense, the words "before extraordinary items" should be inserted. If this is the only unconsolidated subsidiary it might be called "equity in earnings (before extraordinary items) of domestic international sales corporation subsidiary."

The investor's share of the earnings of a DISC subsidiary would include the entire earnings of the subsidiary. The parent should include in its provision for income taxes (rather than as a deduction from its equity in the subsidiary's income) appropriate taxes on income of the subsidiary, after allowing for any dividend credits, etc.

Paragraph 12 of APB Opinion No. 23 states that if there is sufficient evidence to indicate that there will be indefinite postponement of the distribution of earnings of the subsidiary or that such earnings will be remitted without incurring a liability for taxes, no deferred taxes should be provided on such income until it becomes apparent that such earnings will become taxable. Generally, it would be appropriate to so postpone any provision for income taxes on 50 percent of earnings of DISC subsidiaries.

Postponement would require the disclosures referred to in paragraph 14 of APB Opinion No. 23.

.03 Sales to Domestic Companies Classified as Export Sales

Inquiry—Company A, a domestic manufacturer with a DISC subsidiary, sells manufactured goods to unrelated domestic companies under agreements which assure that the goods will be sold in the export market. Such agreements are necessary to qualify the sales as export sales under DISC regulations. Are such sales “export sales” as contemplated by FASB Statement of Financial Accounting Standards No. 14?

Reply—Such sales may be considered “export sales” under FASB Statement No. 14 because the buyers have agreed that the goods will be exported.

TIS Section 8000**AUDIT FIELD WORK**

TABLE OF CONTENTS*Section***8100 Planning and Supervision**

- .01 Use of Standardized Audit Program

8200 Internal Control

- [.01] Reserved
- .02 Determining Accuracy of Cash Collections for Coin-Operated Machines

8210 Statistical Sampling

- [.01] Reserved
- .02 Selection of the Sampling Unit

8220 Sampling

- .01 Application of SAS No. 39
- .02 Authoritative Guidance Provided by SAS No. 39
- .03 Adequate Size for Nonstatistical Samples
- .04 Documentation Requirements of SAS No. 39
- .05 Methods to Select Representative Sample

8300 Evidential Matter**8310 Evidential Matter: Securities**

- .01 Reliance on Report of Custodian of Securities
- .02 Confirmation of Securities Held in Street Name
[Amended]

8320 Evidential Matter: Inventories

- .01 Reliance on Observation of Inventories at an Interim Date
- .02 Observation of Physical Inventory on a First Audit
- .03 Cost of Inventories Acquired from Principal Stockholder
- .04 Reliance on Estimates of Coal Inventories by Experts
- .05 Dates of Observation of Inventories Which Are Kept on Perpetual Records
- .06 Observation of Consignment Inventories Stored in Public Warehouse [Amended]

Section

8330 Evidential Matter: Fixed Assets

- .01 Verification of Real Estate Ownership
- .02 Examination of Assets of a Rental Company

8340 Evidential Matter: Confirmation Procedures

- .01 Confirmation of Factored Receivables
- .02 Confirmations of Receivables from Governments and Large Corporations
- .03 Confirmation of Balances Due on Loans
- .04 Reporting Additional Paid-up Insurance on Standard Confirmation Inquiry
- .05 Confirmations for a Broker or Dealer in Commodity Options [Amended]
- .06 Wording of Confirmation Request Forms
- .07 Signature on Bank Confirmation Form
- .08 Use of Postage-Paid Return Envelopes
- .09 Insurance Claims
- .10 Letter of Inquiry to Client's Attorney
- .11 Receivables in Cash Basis Financial Statements
- .12 Letter of Inquiry to Client's Attorney Concerning Unasserted Claims [Amended]
- .13 Negative Confirmations
- .14 Bank Confirmation Forms Requesting Customer Account Numbers

8900 Other Auditing Procedures

- .01 Use of Tick Marks on Client's Records [Amended]
 - .02 Communications Between Predecessor and Successor Auditors
 - .03 Obtaining Written Representation from Management
 - .04 Possible Existence of Fraud
 - .05 Communications Between Predecessor Accountant and Successor Auditor
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➡ The next page is 8321. ⬅

Section 8100

Planning and Supervision

.01 Use of Standardized Audit Program

Inquiry—A publishing house sells a preprinted audit program. May a CPA use such an audit program?

Reply—It is not generally desirable to begin a job with a pre-designed audit program unless the program is designed for the specific industry involved. Such a program would either include voluminous material not applicable to the majority of engagements, or the program would require extensive additional material. In the latter case, the danger of omitting significant audit procedures would appear greater with a preprinted program than if a program were designed for the particular engagement.

The standard auditor's opinion calls for application of "such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances." For an auditor to rely on determination by someone else of the procedures considered necessary in the circumstances would cast doubt as to whether he is exercising due professional care in the performance of the examination.

»→ *The next page is 8371.* ←«

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.

➡ *The next page is 8471.* ←

Section 8210

Statistical Sampling

.02 Selection of the Sampling Unit

Inquiry—Should a voided check be included as one of the sampling units?

Reply—Whether or not to include voided checks depends on what is being sampled. If an auditor is sampling “all payments made during the period”, a voided check is not evidence of a payment and should not be included. If an auditor is sampling “all checks processed during the period”, a voided check is evidence of a processed check and should be included.

➤ *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 compliance testing to test those aspects of accounting 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 compliance with a control procedure 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 compliance tests (paragraphs 31 through 42) applies when sampling techniques are used to test documented controls on which he intends to rely. 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 review 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 review 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 review 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.

(The above response is consistent with an item in "The CPA Letter" dated August, 1983.)

.02 Authoritative Guidance Provided by SAS No. 39

Inquiry—What new authoritative guidance about the application of audit sampling to substantive tests is provided by SAS No. 39?

Reply—SAS No. 39 adds the following seven specific provisions to professional standards:

- The concept that some items exist for which, in the auditor's judgment, acceptance of some sampling risk is not justified, and which should be examined 100 percent (paragraph 21). This simply reminds the auditor that some of the items he encounters in an examination of financial statements may individually be so significant or may have such a high likelihood of being in error or misstated that they should not be sampled. Instead, all items of that nature should be examined.
- The suggestion that the efficiency of a sample may be improved by separating items subject to sampling into relatively homogeneous groups based on some characteristic (paragraph 22). This indicates that audit efficiency can sometimes be improved by, for example, stratifying or segregating the items comprising a balance or class of transactions into groups based on their individual dollar value or some other classification.
- A requirement that the auditor consider tolerable error in planning audit sampling applications in his examination of account balances and classes of transactions (paragraph 18). This simply asks the auditor to consider, in the early stages of an audit, how much error he will be able to tolerate for each balance and class of transactions that is sampled, in combination with errors in other accounts, and still render an unqualified opinion on the financial statements. SAS No. 39 simply asks

the auditor to *consider* tolerable error and to recognize that it is one of the factors that influences sample size. There is no requirement to document or quantify tolerable error.

- A requirement that the auditor select a sample that can be expected to be representative of the pertinent account balance or class of transactions (paragraph 24). Simply put, this means that each item or dollar in the population being sampled should have a chance of being selected, not necessarily an equal chance of being selected.
- A requirement that the auditor consider selected sample items to which he is unable to apply planned audit procedures in order to determine their effect on his evaluation of the sample (paragraph 25). For example, sometimes the auditor may be precluded from applying planned audit procedures to selected sample items because supporting documentation may be missing. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be in error, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class is materially in error, the auditor should consider alternative procedures that would provide him with sufficient evidence to form a conclusion.
- A requirement that the auditor project the error results of the sample to the items from which the sample was selected (paragraph 26). Since the sample is expected to be representative of the population from which it was selected, errors found are also expected to be representative of the population. This simply asks the auditor to measure the likely error in the population from which the sample was drawn, giving appropriate consideration to sampling risk, and to consider it in reaching his conclusion.
- A requirement that the auditor consider, in the aggregate, projected error results for all audit sampling applications and all known errors from nonsampling applications when he evaluates whether the financial statements taken as a whole may be materially misstated (paragraph 30).

(The above response is consistent with an item in “The CPA Letter” dated August, 1983.)

.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 error 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 error 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.

(The above response is consistent with an item in “The CPA Letter” dated August, 1983.)

.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 error.
- The method of sample selection.
- A list of errors identified in the sample.
- An evaluation of the result of the sampling application.
- Conclusions reached by the auditor.

(The above response is consistent with an item in "The CPA Letter" dated August, 1983.)

.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 large 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.

(The above response is consistent with an item in "The CPA Letter" dated August, 1983.)

➤➤➤→ *The next page is 8521.* ←➤➤➤

Section 8310

Evidential Matter: Securities

.01 Reliance on Report of Custodian of Securities

Inquiry—A bank acts as a custodian for the securities investments of a client. The bank furnishes the client with monthly reports showing all transactions such as sales, purchases, interest and dividends received, and the current market value of the investments. Can the auditor rely on this custodial report, or must the securities be physically examined?

Reply—Whether the custodial report of the bank, supplemented by direct correspondence from the bank to the auditor, is adequate evidence of the existence and ownership of the investment securities held by the bank would depend primarily on the relationship between the value of the securities held and the financial resources of the bank.

It is usual practice where such investments are held in an amount which is not material to the resources of the bank to accept a confirmation of responsibility by the bank as adequate evidence of existence of the asset.

Where the value of the securities is material in relation to the resources of the bank, it may be necessary to visit the bank to determine that the securities are held in the name of the investing company, or if held in “street” name or in the name of the bank that the securities are in fact segregated. The bank will usually have an internal document attached to each such certificate (or group of certificates) indicating the owner for which they are held. Prior arrangements may be made by the client with bank authorities so that the auditor may, on a surprise basis, go to some officer of the bank and be led directly to the vault to examine the shares certificates and the evidence that such certificates are held for the client.

If such physical examination of the securities is necessary, it will frequently be appropriate to reconcile (possibly on a test basis) the certificate numbers of securities held with certificate numbers held at the date of the preceding examination, adjusted for subsequent sales and purchases.

.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]

➡ *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—Section 331.09-.12 of Statement on Auditing Standards No. 1 discusses evidential matter regarding inventories. Section 331.10 of SAS No. 1 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.” Section 331.12 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 section 331.12 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 331.01-.09 of Statement on Auditing Standards No. 1 and paragraphs 10-13 of SAS 2 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.

.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 docu-

ments 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-.15 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]

➤➤➤➤➤ *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.

➡ ➡ ➡ *The next page is 8731.* ← ← ←

Section 8340

Evidential Matter: Confirmation Procedures

.01 Confirmation of Factored Receivables

Inquiry—When accounts receivable are sold to a factor under a factoring agreement, is confirmation of these receivables necessary?

Reply—The AICPA Industry Audit Guide, *Audits of Finance Companies* (1973), discusses factoring arrangements on pages 12-14 and 108-109. As indicated in the guide, the factor assumes the credit checking, bookkeeping, and collection responsibilities of his client and generally assumes the credit risk, unless the account is purchased on a recourse basis, under which arrangement, the credit risk remains with the client. Under either arrangement, the client remains contractually responsible for any claims or disputes with the customer.

For financial reporting purposes, purchased receivables are shown as an asset in the factor's balance sheet and the unpaid portion of the purchase price as a liability "due to clients." Overadvances sometimes granted to clients, and generally secured by other assets such as inventory and fixed assets, are segregated from purchased receivables and reported as "due from factored clients."

Since the audit guide indicates that the purchased receivables are shown as assets on the factor's balance sheet, it seems that the factor's auditors should confirm these receivables in accordance with Sections 331.03-331.08 of Statement on Auditing Standards No. 1. If the receivables are purchased on a nonnotification basis, the factor's auditors may request their customer's auditors to confirm the balances in the customer's name because the debtors would have no knowledge that their accounts had been factored.

.02 Confirmations of Receivables From Governments and Large Corporations

Inquiry—It is often difficult to get replies to confirmation re-

quests from large corporations and governmental agencies. What procedures can be followed to confirm these accounts?

Reply—The problems of obtaining confirmation of receivables from large multi-office corporations as well as from various government agencies generally involves identifying the individual who is in a position to give assurance as to the validity of the receivable. Very frequently this will make impossible confirmation of all receivables from a particular company by one confirmation request. However, by limiting the test of the receivables from any such company to a fair sampling, by identifying the voucher numbers or order numbers involved, and by care in selecting the accounting center and possibly the individual to whom a request is sent, it is sometimes possible to obtain confirmation of an appropriate number of items from each such account despite the form letter that is sent out in reply to a request for confirmation of the overall balance due, a company is generally willing to respond to a request which can be answered without an undue amount of research.

There may, however, be occasions on which the company will not respond to confirmation requests. In such instances if remittance advices are obtained, they usually will adequately identify a remittance so that it can be related directly to the invoice against which it is being applied. If the auditor is satisfied that the date of receipt of the accompanying remittance was subsequent to the cut-off date for examination of receivables, this will frequently be an application of “other auditing procedures” adequate to meet the requirements of paragraph 12 of Statement on Auditing Standards No. 2.

.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 can not 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.

.04 Reporting Additional Paid-up Insurance on Standard Confirmation Inquiry

Inquiry—The *Standard Confirmation Inquiry for Life Insurance Policies* made available by the AICPA does not appear to have a place for including “additional paid-up insurance” which is usually acquired by the owner with policy dividends. How should this item be confirmed?

Reply—One of the original drafts of the confirmation form did provide for additional paid-up insurance, but it was deleted as nonessential since the primary purpose of the form is to determine the cash surrender value of the policies. As the form is currently constructed, the information regarding additional paid-up coverage would appear at item No. 1, although “face amount of basic policy” does not really describe it accurately, and an insurance company might misinterpret the request.

.05 Confirmations for a Broker or Dealer in Commodity Options

Inquiry—AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, states on page 107:

Accounts Carried by other Brokers and Dealers in Commodities.
... The auditor should consider requesting from such other carrying brokers or dealers, with whom accounts are maintained, a statement of the account showing any cash balance, securities or open commodity positions long or short.

Does the above reference apply to an audit of a broker or dealer in commodity options?

Reply—The Audit and Accounting Guide applies to a broker or dealer in commodity options. Therefore, the reference on page 107 should be followed in connection with the audit of a broker or dealer in commodity options. [Amended]

.06 Wording of Confirmation Request Forms

Inquiry—What constitutes suitable language for confirmation requests used in (1) an examination of financial statements and (2) procedures related to accounting services?

Reply—The forms used for confirmation requests should state clearly that the client is requesting a reply to be sent to the CPA. The forms used for information requests for unaudited financial statements should not refer to “an examination”. Suggested wording follows:

Please send the following information to _____,
professional accountants, who are performing services for
the company:

.07 Signature on Bank Confirmation Form

Inquiry—The standard bank confirmation includes a line designated “authorized signature”. The client would prefer not to sign the confirmation request to speed up the confirmation procedure. Is this advisable?

Reply—The signature of an authorized signatory is necessary to authorize the bank to disclose the information requested. A signature should be required.

.08 Use of Postage-Paid Return Envelopes

Inquiry—Is it necessary or required under generally accepted auditing standards for an auditor to send a postage-paid return envelope with a positive confirmation request?

Reply—Although not required, the preponderant current practice is to send postage-paid return envelopes with positive confirmation requests in the United States to facilitate responses.

.09 Insurance Claims

Inquiry—Should a CPA communicate with the attorneys representing the insurance company or with the insurance company in order to obtain evidential matter as to claims outstanding against a client?

Reply—The CPA should obtain evidential matter on claims outstanding from the client and by communicating with the client's legal counsel under SAS No. 12. Communication with the insurance company would be sufficient for obtaining additional evidential matter concerning claims outstanding.

.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 valid.

The client reported that no legal problems were pending for the year under audit, but currently litigation was possible. Do generally accepted auditing standards require that the client send a letter of inquiry to an attorney?

Reply—Generally accepted auditing standards as set forth in SAS No. 12 require that a letter of inquiry be sent to an attorney if the auditor has knowledge that an attorney has been consulted. If the auditor has no evidence of outstanding legal matters, and the client has not consulted an attorney, the auditor is not required to confirm with a consulting attorney the absence of litigation.

.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.

.12 Letter of Inquiry to Client's Attorney Concerning Unasserted Claims

Inquiry—SAS No. 12, Appendix A, presents an illustrative audit inquiry letter to be sent to legal counsel if unasserted claims and assessments exist. Auditing Interpretation, "Form of Audit Inquiry Letter When Client Represents that No Unasserted Claims and Assessments Exist" specifies how to revise the illustrative audit inquiry letter if unasserted claims and assessments do not exist. The Interpretation states:

Unasserted claims and assessments—We have represented to our auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed, in accordance with FASB Statement No. 5. (The second paragraph in the section relating to unasserted claims and assessments would not be altered.)

Which paragraph is the second paragraph that the Interpretation refers to?

Reply—The second paragraph in Appendix A is the paragraph that starts with “We understand that whenever . . .” That paragraph alerts legal counsel of the client’s understanding of legal counsel’s professional responsibilities and may prompt legal counsel to advise the client of unasserted claims and assessments that the client has not brought to the attention of the auditor.

The Auditing Interpretation, “Alternative Wording of the Illustrative Audit Inquiry Letter to a Client’s Lawyer,” *AICPA Professional Standards*, Volume 1, section 9337.13, illustrates a complete audit inquiry letter modified for situations when, among other things, the client represents that there are no unasserted claims. (Amended)

.13 Negative Confirmations

Inquiry—Is it acceptable to use only negative accounts receivable confirmations?

Reply—SAS No. 1, section 331, *Receivables and Inventories*, describes the use of negative and positive confirmations. Paragraph 5 states:

Because the use of the positive form results in either (a) the receipt of a response from the debtor constituting evidence regarding the debt or (b) the use of other procedures to provide evidence as to the validity and accuracy of significant non-responding accounts, the use of the positive form is preferable when individual account balances are relatively large or when there is reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. The negative form is useful particularly when internal control surrounding accounts receivable is considered to be effective, when a large number of small balances are involved, and when the auditor has no reason to believe the persons receiving the requests are unlikely to give them consideration.

Paragraph 5 also indicates that if negative rather than positive confirmations are used, it is normally necessary to send more requests or to perform more extensive auditing procedures

to obtain reasonable assurance with respect to the accounts receivable balances. Accordingly, a combination of positive and negative confirmations is frequently used in practice.

.14 Bank Confirmation Forms Requesting Customer Account Numbers

Inquiry—Certain banks are requesting that exact account names and customer account numbers be indicated on the standard bank confirmation form used to confirm bank balances. Does such a request by the bank present a problem to an auditor in that the entity being audited might not inform the auditor of all bank accounts?

Reply—The fact that the banks ask for exact account names and customer account numbers in order to confirm balances does not present a significant problem for the independent auditor.

The confirmation of bank balances is one of several procedures related to cash balances performed in an examination in accordance with generally accepted auditing standards. The results from the combination of procedures performed provides the basis for the auditor's conclusions related to the cash accounts.

➡ *The next page is 8991.* ←

Section 8900

Other Auditing Procedures

.01 Use of Tick Marks on Client's Records

Inquiry—In the course of an audit is it an acceptable practice to make tick marks on the client's accounting records?

Reply—The accounting records are, of course, the property of the client. Therefore, whether tick marks can be made on the client's records should be discussed with the client. However, marks may leave an undesirable trail for the client's employees of the exact extent and method of testing. Generally tick marks should be as inconspicuous as possible. [Amended]

.02 Communications Between Predecessor and Successor Auditors

Inquiry—A successor auditor believed that information provided by a client explained clearly the reason for a change in auditors and indicated the change was not due to a dispute regarding accounting policies. Therefore, the successor auditor did not communicate with the predecessor auditor. Was the successor auditor justified in not communicating with the predecessor auditor?

Reply—A successor auditor who relies solely on information obtained from the client is not only imprudent but also fails to observe generally accepted auditing standards included in SAS No. 7. SAS No. 7 provides that a successor auditor make specific and reasonable inquiries of the predecessor auditor.

.03 Obtaining Written Representation from Management

Inquiry—SAS No. 19 requires an auditor to obtain a written representation from management. If an auditor believes that a written representation from management is not essential to express an opinion on the financial statements examined and consequently does not obtain the written representation, can the auditor express an unqualified opinion?

Reply—If an auditor states in his report that he is expressing an opinion based on an examination made in accordance with generally accepted auditing standards, he would be unable to express an unqualified opinion unless he obtained a written

representation from management. The matters included in a written representation vary for different engagements. As a minimum, management acknowledges that it is responsible for the fair presentation of the financial statements on which the auditor is expressing an opinion. The representation serves to emphasize that management, not the auditor, is responsible for the financial statements.

.04 Possible Existence of Fraud

Inquiry—SAS No. 16, paragraph 10, provides examples of conditions that may cause the auditor to be concerned about the possibility that management may have made material misrepresentations in the financial statements. Have examples of other conditions or events that may signal the possibility of material misrepresentations or a fraud situation been developed?

Reply—Yes. An AICPA subcommittee compiled the following suggested list of conditions or events which may signal the possible existence of a fraud situation. The list was published in the March 12, 1979 edition of *The CPA Letter*.

1. Highly domineering senior management and one or more of the following, or similar, conditions are present:
 - An ineffective board of directors and/or audit committee.
 - Indications of management override of significant internal accounting controls.
 - Compensation or significant stock options tied to reported performance or to a specific transaction over which senior management has actual or implied control.
 - Indications of personal financial difficulties of senior management.
 - Proxy contests involving control of the company or senior management's continuance, compensation or status.
2. Deterioration of quality of earnings evidenced by:
 - Decline in the volume or quality of sales (for example, increased credit risk or sales at or below cost).
 - Significant changes in business practices.
 - Excessive interest by senior management in the earnings per share effect of accounting alternatives.

3. Business conditions that may create unusual pressures:
 - Inadequate working capital.
 - Little flexibility in debt restrictions such as working capital ratios and limitations on additional borrowings.
 - Rapid expansion of a product or business line markedly in excess of industry averages.
 - A major investment of the company's resources in an industry noted for rapid change, such as a high technology industry.
4. A complex corporate structure where the complexity does not appear to be warranted by the company's operations or size.
5. Widely dispersed business locations accompanied by highly decentralized management with inadequate responsibility reporting system.
6. Understaffing which appears to require certain employees to work unusual hours, to forgo vacations and/or to put in substantial overtime.
7. High turnover rate in key financial positions such as treasurer or controller.
8. Frequent change of auditors or legal counsel.
9. Known material weaknesses in internal control which could practically be corrected but remain uncorrected, such as:
 - Access to computer equipment or electronic data entry devices is not adequately controlled.
 - Incompatible duties remain combined.
10. Material transactions with related parties exist or there are transactions that may involve conflicts of interest.
11. Premature announcements of operating results or future (positive) expectations.
12. Analytical review procedures disclosing significant fluctuations which cannot be reasonably explained, for example:
 - Material account balances.
 - Financial or operational interrelationships.

- Physical inventory variances.
 - Inventory turnover rates.
13. Large or unusual transactions, particularly at year-end, with material effect on earnings.
 14. Unusually large payments in relation to services provided in the ordinary course of business by lawyers, consultants, agents and others (including employees).
 15. Difficulty in obtaining audit evidence with respect to:
 - Unusual or unexplained entries.
 - Incomplete or missing documentation and/or authorization.
 - Alterations in documentation or accounts.
 16. In the performance of an examination of financial statements unforeseen problems are encountered, for instance:
 - Client pressure to complete audit in an unusually short time or under difficult conditions.
 - Sudden delay situations.
 - Evasive or unreasonable responses of management to audit inquiries.

.05 Communications Between Predecessor Accountant and Successor Auditor

Inquiry—An accountant is engaged to examine 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—Yes. The fact that the prior year's financial statements were reviewed does not relieve the successor auditor of responsibility for communicating with the predecessor accountant.

SAS No. 7, *Communications Between Predecessor and Successor Auditors*, applies whenever an accountant has been retained, or is to be retained, to make an examination of financial statements in accordance with generally accepted auditing standards. According to SAS No. 7, paragraph 4, "Inquiry of the

predecessor auditor is a necessary procedure because the predecessor may be able to provide the successor with information that will assist him in determining whether to accept the engagement.”

TIS Section 9000

AUDITORS' REPORTS

TABLE OF CONTENTS*Section***9100** **Conformity with Generally Accepted Accounting Principles****9110** **Compliance Reports**

[.01] Reserved

[.02] Reserved

[.03] Reserved

 .04 **Auditors' Reports on Local Governments** .05 **Internal Control Reports for Stock Transfer Agents** .06 **Reference in the Auditor's Report to Generally Accepted
 Government Auditing Standards** .07 **Compliance With Guideline for U. S. Government Secu-
 rities Dealers****9200** **Consistency**

[.01] Reserved

9210 **Accounting Changes** .01 **Reasons for the Cumulative Effect of Accounting Changes** .02 **Change in Accounting for Pre-operating Costs** .03 **Change in Service Lives of Fixed Assets** .04 **Disclosure of Change in Fiscal Year** .05 **Change in Method of Applying Overhead**

[.06] Reserved

[.07] Reserved

 .08 **Change in Accounting Estimate for Discounted Receivables** .09 **Changes in Reporting Entity** .10 **Change from Generally Accepted Accounting Principles to
 Another Comprehensive Basis of Accounting****9300** **Disclosure****9310** **Errors and Irregularities** .01 **Effect on Auditor's Opinion of Failure to Record Liability** .02 **Disclosure of Corporation's Political Contributions** .03 **Auditor's Request to Extend Scope of Examination****9320** **Uncertainties**

[.01] Reserved

 .02 **Disclosure of Potential Tax Liability of Uncertain Amount
 [Amended]** .03 **Litigation of Uncertain Effect on Financial Statements**

Section

- 9320 Uncertainties—Continued**
- [.04] Reserved
 - .05 Value of Land Subject to Change Based on Rezoning
 - .06 Possible Effect of Divorce Proceedings on Credit Rating
 - .07 Governmental Units Accounting and Reporting of Compensated Absences
 - .08 Going Concern Problem—Financial Statements Prepared on the Income Tax Basis of Accounting
- 9330 Subsequent Events**
- .01 Failure to Remit Withholding Taxes in Subsequent Period [Amended]
 - .02 Disclosure of Note Receivable Covering Previous Account of Bankrupt Company
 - .03 Discovery of Potential Liability in Subsequent Period
- 9390 Other Disclosure Requirements**
- .01 Disclosure of Agreement Between Principal Stockholders
 - .02 Disclosure of Dependence on Sales Activity of Principal Stockholder
 - .03 Effect on Auditor's Opinion of Trustee's Management of Investment Funds
 - [.04] Reserved
 - .05 Disclosure of Economic Dependency [Amended]
- 9410 Audited Financial Statements**
- .01 Audit Requirements for Regulation A Corporation
 - .02 Going Concern Assumption for Venture with Limited Life
 - .03 Opinion on Balance Sheet Only
 - .04 Opinion on Balance Sheet with Disclaimer on Income Statement [Amended]
 - .05 Unqualified Opinion on Both Consolidated and Equity Basis Statements
 - .06 Reference in Financial Statements to Auditor's Report [Amended]
 - [.07] Reserved
 - .08 Auditor's Restriction on Reproduction of Financial Statements
 - .09 Arrangement of References to Financial Statements in Auditor's Report
 - .10 Substitution of Term "Audit" for "Examination" in Auditor's Report [Amended]
 - [.11] Reserved
 - .12 Basic Financial Statements Based on LIFO Inventory—Supplemental Statements Based on FIFO Inventory
 - .13 Classification of Certain Callable Obligations
 - .14 Compilation of Supplementary Schedules in Audited Financial Statements
 - .15 Condensed Financial Statements of a Nonpublic Entity

Section

- 9420 Unaudited Financial Statements of Public Entities**
[.01—.28] Reserved
- 9430 Signing and Dating Reports**
 .01 Use of Successor Firm Name in Signing Registration Statement [Amended]
 .02 Reporting on Companies with Different Fiscal Years
 .03 Dates of Representation Letter and Auditor's Opinion
 [.04] Reserved
- 9510 Special Reports**
 .01 Determination of Sales Price Based on Auditor's Report
 [.02] Reserved
 .03 Audit of Sales for Percentage-of-Sales Lease Agreements
 [.04] Reserved
 [.05] Reserved
 .06 Middle Paragraph of Report on Cash Basis Financial Statements
 .07 Statement of Cash Receipts and Disbursements
 .08 Statutory Basis Financial Statements Differ from GAAP
 .09 State Accounting Guide Differs from GAAP
 .10 Bank Directors' Examination
- 9520 Reliance on Others**
 .01 Definition of "Principal Auditor"
 .02 Responsibility for Audit of Dividend Fund Managed by Agent
 .03 Reliance on Internal Auditors
 .04 Reliance on State Grain Inspectors for Inventory Measurements
 .05 Non-Independent CPA Firm's Association With an Audit
- 9530 Limited Scope Engagements**
 .01 Auditor's Report if Inventories Not Observed—I
 .02 Auditor's Report if Inventories Not Observed—II
 [.03] Reserved
 [.04] Reserved
 [.05] Reserved
 .06 Distinctions Between Scope Limitations
 .07 Inadequate Internal Controls and Financial Records
 .08 Effects of Scope Limitation on Auditor's Opinion
 .09 Letter of Audit Inquiry Not Sent to Client's Legal Counsel
- 9540 Pro Forma Financial Statements**
 [.01] Reserved

Section

9600

Compilation and Review Engagements

- .01 Compiled Financial Statements Not Adjusted
- .02 Inquiries for a Review Engagement
- .03 Working Trial Balance [Amended]
- .04 Financial Statements Marked as Unaudited
- [.05] Reserved
- .06 Disclosure for Compiled or Reviewed Financial Statements Prepared on a Comprehensive Basis of Accounting Other than GAAP
- [.07] Reserved
- .08 Supplementary Information [Amended]
- .09 Application of SSARS No. 3 to Certain Companies Required to File with Regulatory Bodies
- .10 Review of Financial Statements Included in a Prescribed Form
- .11 Computer Generated Financial Statements
- .12 Interim Cash Basis Statements and Year-End Accrual Basis Statements
- .13 Compiled or Reviewed Financial Statements Prepared on the Liquidation Basis
- .14 Uncertainties/Going-Concern Problems
- .15 Consistency
- .16 Reference to Accountant's Report in Notes to Financial Statements
- .17 Modification of Compilation Report on Prospective Financial Statements
- .18 Bank Engaged a CPA Firm to Compile a Financial Statement of Another Entity [Amended]
- .19 Issuance of an Audit Report on Financial Statements Which Have Already Been Reviewed
- .20 Reissuance When Not Independent
- .21 Income Taxes Omitted on Interim Financial Statements

9900

Other Reporting Problems

- [.01] Reserved
- .02 Furnishing Unbound Reports to Clients
- .03 Dates on Cover for Financial Statements [Amended]
- .04 Use of "Accountants' Report" for a Disclaimer of Opinion
- .05 Divisional Financial Statements
- .06 Break-Even Financial Statements
- .07 Financial Statements Cover Period Longer Than Twelve Months

➡ *The next page is 9321.* ←

Section 9110

Compliance Reports

.04 Auditors' 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 treasurer. 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 his opinion if he has followed the standards prescribed by the state treasurer and he has included a report of comments and recommendations?

Reply—A CPA may state in his 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, it would be proper for a CPA to include in his opinion letter a reference to a report of comments and recommendations if such a report has in fact been issued.

.05 Internal Control Reports for Stock Transfer Agents

Inquiry—The Securities and Exchange Commission (SEC) has adopted new rules affecting banks and other companies that serve as registered transfer agents. Rule 17 Ad-13 now requires an annual study and evaluation of internal accounting control over transfer activities. For banks that are registered transfer agents, the required report on internal accounting control can be obtained from either an independent accountant or internal auditor. The federal bank regulatory agencies are responsible for monitoring banks' compliance with this rule.

The new SEC rules require that the accountants' report describe any material inadequacy found to exist as of the date of the study and evaluation, any corrective action taken, comment on the current status of any material inadequacy described in the immediately preceding report, and indicate the date of the study and evaluation of internal control.

Is the SEC's definition of material inadequacy the same as a material weakness under SAS No. 30, *Reporting on Internal Accounting Control*?

Reply—No. The SEC's definition of material inadequacy is not the same as a material weakness under SAS No. 30. In its comments on the new rules, the SEC stated that the required study and evaluation “. . . is intended to detect weaknesses involving amounts that may not be considered material when compared to the transfer agent's assets, but would be considered material when viewed against the transfer agent's ability promptly and accurately to transfer record ownership and safeguard related securities and funds.” CPAs who perform a study and evaluation under the new SEC rules should be cognizant of this important distinction.

For guidance as to the form of the report, CPAs should refer to SAS No. 30, paragraphs 54 through 59. Additional guidance is provided in the AICPA Industry Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, chapter 3.

(The above response is consistent with an item in *The CPA Letter* dated May 28, 1984.)

.06 Reference in the Auditor's Report to Generally Accepted Government Auditing Standards

Inquiry—May an auditor, who has examined the financial statements of a governmental unit, state in his report that the examination was conducted in accordance with *generally accepted government auditing standards*?

Reply—The authoritative literature does not define *generally accepted government auditing standards*; therefore, a statement that an examination was conducted in accordance with such standards would be unclear. A reference to the financial and compliance audit standards contained in the General Accounting Office's *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, 1981 revision (commonly referred to as the “yellow book”), is more appropriate. The Single Audit Act of 1984 refers to these as generally accepted government auditing standards. When the General Accounting Office issued the 1981 revision of the “yellow book” it recognized (on page 28) that the AICPA requires that public accountants state that their examination was made in accordance with generally accepted auditing standards. Although generally

accepted auditing standards include the compliance standards contained in the “yellow book”, many governmental agencies require a more explicit reference to those compliance standards in the scope paragraph of the auditor’s opinion.

Examples of auditors’ reports on financial statements of governmental units that refer to the standards contained in the above publication and include the required statement that the examination was conducted in accordance with generally accepted auditing standards can be found in Appendix A of the AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units*, pages 198 through 223, and in the AICPA *Audit and Accounting Manual*, section 10,700.

.07 Compliance With Guideline for U. S. Government Securities Dealers

Inquiry—The Federal Reserve Bank of New York’s (Fed) voluntary Capital Adequacy Guideline for U. S. Government Securities Dealers suggests that customers and other dealers require those government securities dealers with whom they do business to provide them with a copy of a letter from the dealer’s certified public accountant stating that it found no material weaknesses in the dealer’s internal systems and controls incident to adherence to the standard. It further states that this letter should be similar to that which must be given to the SEC by registered broker-dealers.

Although the standard says that the letter should be similar to the one provided by dealers to the SEC, there appears to be two differences with the SEC letter and the letter suggested by the Fed. Firstly, the Fed’s guidelines do not provide the auditor with the specific criteria for the evaluation of the adequacy of internal accounting control procedures for their purposes required by SAS No. 30, *Reporting on Internal Accounting Control*, and as illustrated in the AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, i. e., for the auditor to state that it found no material weaknesses in the dealer’s internal systems and controls incident to adherence to the capital adequacy standard. Secondly, internal control letters submitted to the SEC are not automatically available to customers and other dealers just by their requesting a copy from the dealer. If a letter contains discussion of a material inadequacy as defined by SEC Rule 17a-5, then the dealer could just state in the statement of financial condition provided to customers that a

copy of the letter is available at the SEC's Washington office. The letter would still include a comment that the letter is intended solely for the use of management and the SEC and should not be used for any other purpose.

Are auditors of government securities dealers that wish to comply with the Fed's guidelines required to follow the guidance and requirements of SAS No. 30 and the audit and accounting guide when issuing reports on the dealer's internal control systems or are they permitted to issue a letter as outlined in the Fed's Capital Adequacy Guideline and allow the distribution of copies of the letter to dealer customers and other dealers?

Reply—Auditors of government securities dealers that are engaged to report on the dealer's system of internal accounting control as part of an audit are required to follow the guidance in SAS No. 30, paragraphs 47 through 53, and as discussed in more detail for broker-dealers in the audit and accounting guide, including the restricting of the distribution of the report to management, a specified regulatory agency or other specified third party. Because the Fed capital adequacy guidelines do not provide for any specific criteria to evaluate controls for their specific purposes, it would not be appropriate for the auditor to comment on the dealer's adherence to these standards.

The auditor is not precluded from expressing an opinion on the dealer's system of internal accounting control as of a specified date *if* the auditor performs an examination of the system as outlined in SAS No. 30, paragraphs 3 through 46. The distribution of the report in this engagement is unlimited. Such a report would meet the requirements as stated in the capital adequacy guidelines but would of course entail considerably more work and cost than the study and evaluation performed in conjunction with the audit engagement.

➡ The next page is 9521. ←

Section 9210

Accounting Changes

.01 Reasons for the Cumulative Effect of Accounting Changes

Inquiry—According to Accounting Principles Board Opinion No. 20, the cumulative effect of a change in accounting must be included in income of the current period. It seems that this would cause the income statement to give a poor picture of operations since an increase or decrease from the prior periods' income would not necessarily show that the company was doing better or worse. Why, then, should the cumulative effect of the change be shown in the current period?

Reply—The reason for this method of reporting is indicated in paragraph 18 of APB Opinion No. 20:

The Board believes that, although they conflict, both (a) the potential dilution of public confidence in financial statements resulting from restating financial statements of prior periods and (b) consistent application of accounting principles in comparative statements are important factors in reporting a change in accounting principles. The Board concludes that most changes in accounting should be recognized by including the cumulative effect, based on a retroactive computation, of changing to a new accounting principle in net income of the period of the change . . . but that a few specific changes in accounting principles should be reported by restating the financial statements of prior periods . . .

Therefore, the cumulative effect approach represents a practical solution to this conflict.

.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 pre-operating cost to expensing such costs as they are incurred.

May the client restate the prior year's financial statements under the provisions of paragraph 29 of Accounting Principles Board Opinion No. 20?

Reply—The special exemption provisions of paragraph 29 apply only to those cases where there is a "forthcoming public

offering'' of shares of equity securities 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 which require cumulative effect reporting should be applied. Paragraph 29 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—Accounting Principles Board Opinion No. 20 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.

.04 Disclosure of Change in Fiscal Year

Inquiry—What disclosure, either in the financial statements or in the auditor's report, is necessary when a company changes its fiscal year?

Reply—Neither Accounting Principles Board Opinion No. 20, *Accounting Changes*, nor Statement on Auditing Standards No.

1, section 420, *Consistency of Application of Generally Accepted Accounting Principles*, specifically discuss a change in the fiscal year. The effect of making the change should be disclosed in the current period under the third standard of reporting. The auditor's opinion need not refer to the change provided the effect of the change is adequately disclosed.

.05 Change in Method of Applying Overhead

Inquiry—A client has used a percentage of direct labor in work in process inventories to determine the amount of applicable overhead. The percentage of direct labor concept became too broad and refinements were necessary to determine overhead for various types of jobs. Due to these refinements, overhead in inventory was decreased. Is this considered a change in accounting estimate or a correction of an error in previously issued financial statements?

Reply—The adjustment made for the change in overhead is not considered an error. APB Opinion No. 20, paragraph 13, discusses correction of an error in previously issued financial statements. Among the statements in paragraph 13 is the following:

A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error for purposes of applying this Opinion.

In the problem presented, the application of overhead on the basis of direct labor costs is not considered a method that is not “generally accepted.”

APB No. 20, paragraph 7, states, “A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes ‘not only accounting principles and practices but also the methods of applying them.’” It appears that a change in the method used in applying overhead is a change in a method of applying accounting principles and, therefore, should be reported in accordance with APB Opinion No. 20, paragraphs 17, 19, 20 and 21.

.08 Change in Accounting Estimate for Discounted Receivables

Inquiry—Corporation A is contingently liable for the repossession of buyer receivables upon their default for nonpayment. In the past year the volume of defaults has increased. If Cor-

poration A increases its allowance for defaults as a result of such experience, is the increase in the allowance an accounting change?

Reply—The term accounting change is defined in APB Opinion No. 20, paragraph 6, as a change in (a) an accounting principle, (b) an accounting estimate, or (c) the reporting entity. Changes in estimates are further discussed in paragraphs 10 and 11 of the Opinion and paragraphs 31 to 33 indicate how a change in estimate should be reported and disclosed.

The increase in the allowance represents a change in accounting estimate and should be reported and disclosed in accordance with APB Opinion No. 20, paragraphs 31 to 33.

.09 Changes in Reporting Entity

Inquiry—SAS No. 1, section 420, paragraphs 7 through 9, 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 paragraphs 7(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, 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 opinion. Changes that require such recognition are those that can be arbitrarily made by management.

.10 Change from Generally Accepted Accounting Principles to Another Comprehensive Basis of Accounting

Inquiry—A Company has changed its method of accounting from generally accepted accounting principles to another comprehensive basis of accounting for the current year. An unqualified accountant's report was issued on the prior year's financial statements. The Company intends to continue to issue comparative financial statements. This situation represents a change from generally accepted accounting principles to another comprehensive basis of accounting and APB Opinion No. 20 does not offer any guidance regarding how to account for

such a change. It appears that the cumulative effect of the change in accounting basis could be handled in one of two ways:

1. The cumulative effect of the change in accounting basis could be included in the income statement of the current year (year of change).
2. The prior year's statements could be restated for the cumulative effect of the change in accounting basis. The beginning "retained earnings" balance for the earliest year presented could be restated to reflect the cumulative effect of the change up to that point in time. Then the financial statements for the earlier year(s) could be presented under the comprehensive basis of accounting to which the company has changed.

Which of the above would be the appropriate statement presentation? How would this change in accounting affect the accountant's report?

Reply—Authoritative literature does not address accounting for a change from generally accepted accounting principles to another comprehensive basis of accounting. In this situation, restatement of prior period financial statements appears to be the preferable approach. Restatement allows the users to compare all periods presented since they will then be on the same basis.

When there is a change in the basis of accounting from generally accepted accounting principles to another comprehensive basis of accounting, some accountants believe that—

- The explanatory paragraph of the auditor's report describing the basis of accounting used should indicate that the basis was adopted during the current year and that the prior-year financial statements have been restated.
- The consistency reference in the opinion paragraph refers to consistent application of principles within a basis of presentation, not the consistent use of the basis of presentation; therefore, a change in basis of presentation of financial statements from generally accepted accounting principles to another comprehensive basis of accounting does not require the auditor to modify his report concerning consistency.

These two concepts are illustrated in the following example of a report on comparative financial statements in the year of change:

(explanatory paragraph)

As discussed in Note A to the financial statements, in 19X3 the Company adopted a policy of preparing its financial statements on the accrual method of accounting used for federal income tax purposes; consequently, buildings, with an estimated economic useful life of 35 years, are being amortized over 15 years in accordance with the accelerated cost recovery system (ACRS) provided under the Internal Revenue Code, rather than within a reasonable range of the estimated economic useful life of the building as provided by APB Opinion No. 1, "New Depreciation Guidelines and Rules." 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 19X2 have been restated on the income tax basis accrual method of accounting adopted in 19X3.

(opinion paragraph)

In our opinion, the financial statements referred to in the first paragraph present fairly the assets, liabilities, and stockholders' equity of XYZ Company as of December 31, 19X3 and 19X2, and its revenue and expenses for the years then ended, on the basis of accounting described in Note A, which basis has been applied in a consistent manner.

➤➤➤→ *The next page is 9651.* ←➤➤➤

Section 9310

Errors and Irregularities

.01 Effect on Auditor's Opinion of Failure to Record Liability

Inquiry—A client collected a special assessment from the members of his club. The excise taxes on this assessment were never remitted to the federal government, and the liability was never recorded. Is it sufficient to fully disclose this liability in the footnotes and disclaim an opinion in the auditor's report, or is withdrawal from this engagement required?

Reply—When an actual liability exists, it should be recorded. Footnote disclosure is not an alternative since it does not cure the defects in the statements. If the client refuses to record and report this debt, there are two choices of action: 1) express an adverse opinion or 2) withdraw from the engagement.

A disclaimer of opinion is not considered appropriate since there is sufficient information to form an opinion that the financial statements are not fairly presented. Statement on Auditing Standards No. 2, paragraph 45 discusses the use of a disclaimer of opinion.

.02 Disclosure of Corporation's Political Contributions

Inquiry—A corporation made a political contribution to a candidate seeking local public office. Such a contribution is permissible under state law. What, if any, special disclosure requirements are necessary for such a contribution? This contribution is not a deductible item for federal income tax purposes, and it is expressly understood that a corporation cannot make a contribution to a candidate for federal office.

Reply—If the disbursement is expected to further the proper objectives of the corporation, there is no need for any special treatment. If the amount is material to net income, the expense should be appropriately disclosed. Further, if the amount is not deductible for income tax purposes and, therefore, pre-tax accounting income differs materially from the amount reported for income tax purposes, appropriate disclosure should be made in accordance with paragraph 63(c) of Accounting Principles Board Opinion No. 11.

If the disbursements appear to be for the benefit of individual

officers rather than of the corporation itself, and if it appears that the payments are material either to the salaries of those benefited or to the profits of the organization, appropriate disclosure should be made.

.03 Auditor's Request to Extend Scope of Examination

Inquiry—During the testing of internal control, vouching of transactions, and confirmation of bank accounts and loan balances, it became evident to an independent auditor engaged to audit the records of a company that the system of internal control was inadequate and that defalcations had occurred. The auditor informed the board of directors and told them that the audit could not continue without extending the scope of examination. If the Board of Directors does not authorize extending the scope of examination, should the auditor disclaim an opinion on the financial statements?

Reply—Since the auditor has information that any financial statements prepared from the company's records may not be presented fairly in accordance with generally accepted accounting principles, a disclaimer of opinion under these circumstances would not be appropriate.

The auditor's course of action depends on further actions of the Board of Directors. If the Board of Directors does not authorize the auditor to extend the scope of his examination, the auditor should withdraw from the engagement, subject to advice from legal counsel, and advise the Board of Directors in writing of the reasons for withdrawal.

➤➤➤→ *The next page is 9751.* ←➤➤➤

Section 9320

Uncertainties

.02 Disclosure of Potential Tax Liability of Uncertain Amount

Inquiry—A corporation and its officers are under investigation by the Internal Revenue Service. It is alleged that the incomes of a number of the corporation's unconsolidated subsidiaries were allocated artificially over a period of years to avoid the tax surcharge for corporate income over \$25,000.

The revenue agent's report on the civil liability for taxes has not been issued pending resolution of criminal actions against the officers. Even though the company expects to appeal any decisions against it, the client believes that the taxes

➡ *The next page is 9751-3.* ←

and penalties assessed may be substantial—perhaps as much as half of the consolidated net worth of the corporation.

How should the potential liability be disclosed in the financial statements if the amount to be assessed is uncertain? How should the auditor report?

Reply—In view of the magnitude of the amount of possible additional taxes, penalties, and interest involved in relation to the company's net assets, the potential tax liability should be disclosed in the notes to financial statements. The auditor should express a qualified opinion because of the magnitude of the amount of possible additional taxes, penalties, and interest involved in relation to the client's net worth. Note 8 to paragraph 25 of SAS No. 2 indicates that an auditor is not precluded from disclaiming an opinion in cases involving uncertainties. Note disclosure and auditor's report might be as follows:

Note describing potential tax liability:

Note X: The Internal Revenue Service is examining tax returns filed by the corporation and its subsidiaries covering the years ending December 31, 19XX to 19XX inclusive. Informal indications are that charges based on section 482 of the Internal Revenue Code will be asserted against the corporation. Section 482 provides that if two or more organizations, trades, or businesses are owned or controlled by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions or credits between them, if he determines the action is necessary to prevent evasion of taxes or to reflect the income clearly. No revenue agent's report has as yet been issued about additional assessment for deficient taxes, and the corporation has not recorded a liability for contingent additional taxes.

Auditor's report

Scope paragraph: same as auditor's standard report.

Explanatory paragraph:

Note X to the consolidated financial statements describes that the Internal Revenue Service is examining the tax returns of the Corporation and its subsidiaries for the years 19XX to 19XX. Although no notice of additional assessments has been received, the Internal Revenue Service has indicated informally that assessments for additional taxes will be assessed against the Corporation. The amount of such assessments, which could be substantial, cannot be estimated at this time.

Opinion paragraph in part:

In our opinion, subject to the effects of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the accompanying consolidated financial statements. . . .

[Amended]

.03 Litigation of Uncertain Effect on Financial Statements

Inquiry—A company became involved in litigation shortly before its audited financial statements were to be issued. The

company is not aware of having committed the alleged acts which are the basis for the suit.

The money damages claimed in the suit are in an unstated amount, and the company's counsel is unable to determine any specific facts relating to the allegations since the pretrial hearing has not commenced and the summons was not specific as to the charges.

What comments are necessary in the auditor's report concerning the possible litigation?

Reply—SAS No. 2, paragraph 24, states, "The auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a minimal likelihood that resolution of the uncertainty will have a material effect on the financial statements." Since the auditor is not in a position to come to a conclusion concerning the resolution of the suit, he should qualify his opinion in accordance with SAS No. 2, paragraph 25, unless he can assess the lack of basis for the charges on the nature of the allegations or unless the damages are expected to be immaterial.

.05 Value of Land Subject to Change Based on Rezoning

Inquiry—A client has included in his balance sheet undeveloped land valued at \$1,500,000 which represents his cost. This land has been appraised by a qualified independent appraiser for approximately the same amount subject, however, to securing zoning which will allow them to construct townhouses on the property. It is estimated that if the zoning is not obtained the land would be worth no more than \$700,000.

There has been a public hearing concerning the zoning, and the Town Planning Commission has recommended to the town council, who has the zoning authority, that they approve the proposed zoning. The town council has directed the town attorney to draft an ordinance which would accomplish the rezoning. A written opinion has been received from the corporation's attorney who has stated that although this action by the town council is not binding, the chances of approval of the rezoning are good.

Can an unqualified opinion based on the \$1,500,000 amount be given? If not, what would be the effect of a guarantee given by

a stockholder of the client that if the zoning is not approved, he will make up any loss to the corporation?

Reply—It would appear that if there is sufficient uncertainty as to securing the zoning, either an opinion on the financial statements taken as a whole should be disclaimed, or the auditor should express a “subject to” opinion, depending upon the materiality of the effect which denial of the zoning would have on the statement of financial position. (See SAS No. 2, paragraphs 21-26 and 35, concerning uncertainties in financial statements.)

However, if the auditor is satisfied that a guarantee by a stockholder to purchase the land at client's cost was “ironclad” and if there is adequate evidence as to the guarantor's ability to make good on the guarantee, there is no reason to consider that the value of the investment to the client has been impaired. Such a guarantee should of course be disclosed in the financial statements.

.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.

.07 Governmental Units Accounting and Reporting of Compensated Absences

Inquiry—Many governmental units have no historical information on which to base decisions on the probability and range of payments for compensated absences. This lack of informa-

tion is being disclosed in the notes to the financial statements in accordance with NCGA Statement No. 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, paragraph 22, and FASB Statement No. 43, *Accounting for Compensated Absences*, paragraph 6. However, this disclosure indicates that a contingency exists. How would this situation affect the auditor's report?

Reply—SAS No. 2, *Reports on Audited Financial Statements*, paragraphs 21 through 26, discusses reporting when there is an uncertainty. This reporting guidance would apply when compensated absences are not accrued because a reasonable estimate cannot be made.

.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 and is experiencing financial difficulties and its ability to continue in existence is questionable. Since the financial statements are prepared on “an other comprehensive basis of accounting,” is the CPA's report required to include the going concern qualification and/or refer to the uncertainty of the company to continue in existence?

Reply—The CPA is not required to refer to the “going concern” problem in his opinion paragraph, since adjustments for contingent losses and reclassification of assets and liabilities are not required by the income tax law. However, he should use the sample middle paragraph required by SAS No. 14, *Special Reports*, paragraph 5(b) to explain how the income tax basis of reporting differs from generally accepted accounting principles. An example can be found in SAS No. 14, paragraph 8. He may wish to add in this paragraph that the company's continued existence is uncertain. Auditing Interpretation No. 8 of SAS No. 14 entitled, “Adequacy of Disclosures in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles,”* states:

To comply with the third standard of reporting, the auditor should also consider other matters that could reasonably be expected to materially affect the understanding of the finan-

*See AICPA Professional Standards, Volume 1, AU § 9621.34—39.

cial statements, independent of the basis of accounting used, such as (a) contingencies and uncertainties, (b) changes in accounting principles or estimates, (c) related party transactions, (d) restrictions on assets and owners' equity, and (e) subsequent events.

➤➤➤→ *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 conditions 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.

➤→ *The next page is 10,051.* ←➤

Section 9390**Other Disclosure Requirements****.01 Disclosure of Agreement Between Principal Stockholders**

Inquiry—An enterprise under audit has entered into an agreement with its two stockholders (each holding 50 percent of the outstanding stock) that upon the death of the first of the two stockholders, the surviving stockholder will have the option of either (1) having the corporation purchase the stock of the deceased stockholder at a value determined under a formula set forth in the agreement, or (2) causing the corporation to be partially liquidated by paying over to the personal representative of the deceased stockholder, a proportionate part of the assets of the corporation.

Does this type of agreement have to be shown as a commitment in the balance sheet of the corporation in order to comply with requirements of full disclosure?

Reply—The rule of informative disclosure does require that the essential facts of the agreement involving this important commitment be succinctly set forth in a footnote to the financial statements. The footnote should clarify whether one of the options must be exercised; or whether one of the options, or neither, may be exercised. Such disclosure should be on a continuing basis.

.02 Disclosure of Dependence on Sales Activity of Principal Stockholder

Inquiry—The principal stockholder of a corporation is also the corporate secretary and a member of the board of directors, but he is not otherwise involved in management and is not frequently consulted on corporate operations. This man is, however, the company's most productive salesman generating almost half the company's revenues. Is it necessary to disclose to the stockholders the importance of the principal stockholder to the corporation and the significant loss of revenue if he should leave the company?

Reply—It is generally necessary, where the major portion of the company's income is derived from a single source, that such source be disclosed. This would appear to be particularly true

where a major source of income is the result of the unique personal endeavors of a single officer or employee.

.03 Effect on Auditor's Opinion of Trustee's Management of Investment Funds

Inquiry—A municipal school building corporation (SBC) sells bonds to finance the construction of public schools and collects rents from the schools to repay the bonds and interest. The SBC operates through a trustee which is a bank responsible for investing excess funds of the SBC.

The president of the SBC is employed as a principal officer of the trustee bank and manages its insurance department. The bank sells a substantial portion of the insurance coverage to the public schools which includes the property rented to the school by the SBC. A second board member of the SBC administers the function of insuring the school properties and also furnishes one-third of the insurance coverage through his insurance agency.

The trust indenture requires the SBC to have properties appraised by an architect for insurance purposes. Appraisals are made by the state rating bureau which covers all school properties and does not segregate the property related to the SBC as required by the trust. The trust indenture also requires that an audit "covering the operations" shall be furnished.

From their examination of the SBC funds, the auditors have concluded that the trustee has not invested the maximum amount of excess funds. Excess funds are supposed to be invested in U.S. government securities but were invested in a certificate of deposit in the trustee bank. What comments should the auditors include in their report concerning these matters?

Reply—The auditors' conclusion that the trustee could have more profitably employed the funds should not affect their opinion on fair presentation of financial position or results of operations. However, it would be appropriate to express their views in a commentary report, if such a report is rendered.

As the insurance agency bills the beneficiary of the trust for insurance premiums, there is no need to disclose the relationship between the insurance agency and the trustee in a report on the trust. It is assumed that policies have been placed with insurance companies that are independent of the trustee, and that commissions are standard.

The auditors should report any failure to conform to the trust indenture. Thus, if the appraisal by the state rating bureau does not meet the terms of the indenture, the auditors should so report. However, there may be adequate information in the report by the rating bureau to furnish evidence that the insurance carried on the trust property adequately meets the terms of the indenture.

.05 Disclosure of Economic Dependency

Inquiry—Company A owes a substantial amount to its major supplier. If the supplier pressed for payment or ceased shipments, Company A could be put out of business. What type of opinion should the auditor express on the financial statements of Company A?

Reply—FASB Statement No. 21, paragraph 9, states, in part:

. . . the Board notes that it [suspension of Statement No. 14, requirements as to non-public enterprises] does not affect the disclosure of information about economic dependency when such disclosure may be necessary for a fair presentation.

The auditor should be able to express an unqualified opinion provided the business relationship is adequately disclosed and the account is *not delinquent*. If the account is delinquent and the major supplier threatens or actually ceases shipments prior to the date of the auditor's report, the auditor may conclude that a modification of his report is appropriate. See SAS No. 34, paragraph 11. [Amended]

➤➤➤➤➤ *The next page is 10,151.* ➤➤➤➤➤

Section 9410

Audited Financial Statements

.01 Audit Requirements for Regulation A Corporation

Inquiry—A corporation, previously an over-the-counter company, went public in 1960 under Regulation A and sold \$300,000 worth of common stock at that time. No additional sales of stock have been made since then. There are currently less than 500 shareholders and total assets do not exceed \$1,000,000.

The financial statements since 1960 have always been audited, but as an economy measure, the company plans to eliminate the audits in the future.

Is there a requirement that this company must issue audited statements?

Reply—There are no statutory requirements under SEC regulations that require an audit under these circumstances. However, the company should determine if state securities regulations require 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 of 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 any exception in the accountant's opinion 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—If the purpose of the corporation and its expected life are disclosed all along in both the financial statements and related footnotes, no "going concern" qualification would be necessary.

.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 examined the balance sheet of X company as of December 31, 19xx, and the related statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet presents fairly the financial position of X company at December 31, 19xx, in conformity with generally accepted accounting principles applied on the basis consistent with that of the preceding year.

Does such a practice satisfy the CPA's reporting obligation according to Statement on Auditing Standards No. 2?

Reply—Paragraphs 5 and 13 of SAS 2 can be interpreted to justify the expression of an opinion on a balance sheet only. In expressing such an opinion, the scope paragraph need not refer to the examination of related statements which are not being presented. The only information necessary to the readers of this report would concern the examination 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 called for by paragraph 5 of Accounting Principles Board Opinion No. 12 should be considered necessary to fair presentation of the balance sheet. Disclosure as to pension plans, except for the amount of expense for the current year, would also be called for.

.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 paragraph 13 of Statement on Auditing Standards No. 2?

Reply—Since the engagement involves a scope limitation, Statement on Auditing Standards No. 2, paragraph 13, does not

apply because that pertains to examinations that are unrestricted. SAS No. 2, 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 call for this treatment." SAS No. 1, section 542.05 states, "If the independent auditor has not satisfied himself by means of other auditing procedures with respect to opening inventories, he should either disclaim an opinion on the statement of income or qualify his opinion thereon . . ."

If an opinion is disclaimed on the income statement, a disclaimer on the statement of changes in financial position would also be required as illustrated in section 542.05 of SAS No. 1.
[Amended]

.05 Unqualified Opinion on Both Consolidated and Equity Basis Statements

Inquiry—A CPA firm has been requested to give an opinion on financial statements of a parent company with wholly owned subsidiaries. Consolidated financial statements, and separate statements for the parent company with investments in the subsidiaries reported on the equity method are to be issued.

Could an unqualified opinion be issued on financial statements prepared both on the consolidated and the equity methods for the same company?

Reply—Accounting Research Bulletin No. 51, paragraph 24 states:

In some cases parent-company statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent. Consolidating 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.

Accounting Principles Board Opinion No. 18, paragraph 14 states in part:

The equity method is not, however, a valid substitute for consolidation and should not be used to justify exclusion of a subsidiary when consolidation is otherwise appropriate. The Board also concludes that parent companies should account for investments in the common stock of subsidiaries by the equity method in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity.

This last sentence means that the consolidated statements would represent the financial statements of the primary reporting entity, and, if they are issued to the stockholders, the parent's unconsolidated statements could even report the investment in subsidiaries at cost, but the equity method would be acceptable.

Based on the above references, an unqualified opinion on the company's financial statement presented both on a consolidated and on the equity basis in accounting for subsidiaries would not be precluded.

.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 accountant's opinion are an integral part of this financial statement."

The only difference between the two notes is the inclusion of the phrase, "and accountant's opinion." Is a reference to the opinion necessary?

Reply—Section 110.02 of Statement on Auditing Standards No. 1 discusses the distinction between responsibilities of the auditor and management and concludes, "The financial statements remain the representations of the management." Therefore, the accountant's opinion cannot be an integral part of the financial statements, and it is inappropriate to include it by reference.

[Amended]

.08 Auditor's Restriction on Reproduction of Financial Statements

Inquiry—At the close of an audit, the auditors give the client a document which contains the client's financial statements and the "Accountants' Report." The accountants' report, called "Our Report," includes a description of the auditors' examination, an expression of opinion, and necessary explanatory comments regarding the financial statements. On the first page of each document leaving the auditors' office is a caveat worded as follows:

Our reports are issued with the understanding that, without our consent, they may be reproduced only in their entirety. Should it be

desired to issue or publish a condensation or a portion of this report and our name is to be used in connection therewith, our approval must first be secured.

Jones and Company
Certified Public Accountants

Since the financial statements are the representations of the client, the auditors have no right to restrict their reproduction except when they are associated with the statements. The phrase "Our Reports" gives the impression that each and every page contained within the binding are representations of the auditors but only the "Accountants' Report" belongs to the auditors.

The following alternatives are being considered:

1. Do away with the caveat altogether.
2. Reword the caveat for clarity and understandability, but continue to issue as a separate page.
3. Reword the caveat as above, but include it as a third paragraph to the "Accountants' Report."

Which of the above alternatives should the auditors adopt?

Reply—The financial statements and the notes are the client's representations although their form and content are often influenced by the auditor. Therefore, the auditors should define their policy in an engagement letter signed by the client and kept in the auditor's files. This procedure would obviate the necessity of including the caveat with each report and set of financial statements issued.

.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 changes in financial position. 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. 2, paragraph 7 can be used regardless of the order in which the financial statements are presented.

.10 Substitution of Term "Audit" for "Examination" in Auditor's Report

Inquiry—The standard auditor's report states, "We have examined. . . ." and, "Our examination was made in accordance. . . ." Is there any objection to substituting the words "audited" and "audit" for "examined" and "examination" in the auditor's report?

Reply—There is no objection to substituting "audit" for "examination" in the auditor's report. [Amended]

**.12 Basic Financial Statements Based on LIFO Inventory—
Supplemental Statements Based on FIFO Inventory**

Inquiry—Company A presents inventory in basic financial statements based on the LIFO cost method and supplemental financial statements based on the FIFO cost method. How should an auditor's report covering the supplemental statements be worded in an auditor-submitted document?

Reply—Appropriate wording based on guidelines stated in SAS No. 29, paragraph 6, for an auditor's report covering the supplemental financial statements follows:

Our examination was made to enable us to express an opinion on the basic financial statements of Company A for the years ended December 31, 19X2 and 19X1, which are presented in the preceding section of the report. As disclosed, the Company's policy is to prepare its annual financial statements on the last-in, first-out (LIFO) method. The accompanying supplemental balance sheets and supplemental statements of income were prepared for purposes of additional analysis using the first-in, first-out (FIFO) method of inventory valuation and are not a required part of the basic financial statements. Our examination did not include the adjustments made in preparing the supplemental presentations and, accordingly we express no opinion on the supplemental financial statements. The accompanying supplemental financial statements are not intended to present financial position or results of operations.

In addition, the accompanying FIFO presentation should be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. (SAS No. 29, paragraph 13)

.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 issue a “subject to” audit report?

Reply—No. FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor*, 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. 2, *Reports on Audited Financial Statements*, because they do not involve matters whose “outcome is not susceptible of reasonable estimation” (SAS No. 2, paragraph 21). 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.

.14 Compilation of Supplementary Schedules in Audited Financial Statements

Inquiry—When an audit has been performed in accordance with generally accepted auditing standards and the client desires supplementary schedules, can these schedules be compiled in accordance with SSARS 1, *Compilation and Review of Financial Statements*, paragraph 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 examined in accordance with generally accepted auditing standards, the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Fi-*

nancial Statements in Auditor-Submitted Documents, should be followed. SAS No. 29, paragraph 6d, states that the auditor can disclaim an opinion on the accompanying information.

.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, 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.

➡ *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. 15, footnote 3. 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, 1973. To do this, the auditor must assemble figures for the period January 1, 1973, to June 30, 1973, from the financial statements for the year ended June 30, 1973, and figures for the period July 1, 1973, to December 31, 1973, from the financial statements for the year ended June 30, 1974.

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, 1973, and disclaim an opinion for the six months ended December 31, 1973?

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. The footnote to paragraph 12 of Statement on Auditing Standards No. 2 (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 examination of financial statements as of such date until June 30, 1974, 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.

.03 Dates of Representation Letter and Auditor's Opinion

Inquiry—On certain complex audit engagements, the letter of representation is not prepared and submitted to the client for his review and signature prior to a complete review of the audit working papers by a partner of the firm. This working paper review is sometimes completed several weeks subsequent to the completion of the audit field work and, not infrequently, develops additional items upon which the partner feels written representations should be obtained from the client.

Statement on Auditing Standards No. 1, section 560.12 reads in part, "Obtain a letter of representations dated as of the date of the auditor's report." Section 530.01 of SAS No. 1 reads in part, "Generally, the date of completion of the field work should be used as the date of the independent auditor's report." In the situation described above, when should the letter of representation and auditors' opinion be dated? If the letter of representation is dated later than the completion of field work, would the review of subsequent events have to be extended to that date?

Reply—Review of the audit working papers is a part of the auditing procedures leading to the auditors' opinion. The letter of representation focuses on areas developed as a result of the review of the audit working papers and should not be dated later than the auditors' opinion. If the letter of representation is as of a date later than the date of completion of the audit field work, the auditors' opinion should bear the same date, since obtaining a letter of representation is an auditing procedure presumed to be performed prior to the issuance of the auditor's report.

The auditor would not be obligated to extend his subsequent events review to the later date, since the items covered in the

letter of representation result from a review of the working papers which reflect the audit work performed.

➡ *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.

.06 Middle Paragraph of Report on Cash Basis Financial Statements

Inquiry—SAS No. 14, paragraph 8, illustrates reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles. The illustration for a report on cash basis financial statements includes the following middle paragraph:

As described in Note X, the Company's policy is to prepare its financial statements on the basis of cash receipts and disbursements; consequently, certain revenue and the related assets are recognized when received rather than when earned, and certain expenses are recognized when paid rather than when the obligation is incurred. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles.

Is the suggested middle paragraph intended to be a qualification or to be informational?

Reply—The suggested middle paragraph is considered to be informational rather than a qualification of the accountant's opinion. The opinion paragraph of the illustrated report is unqualified as to presentation on the basis of accounting described in the middle paragraph.

.07 Statement of Cash Receipts and Disbursements

Inquiry—What wording should be used in the auditor's report for reporting on a statement of cash receipts and disbursements?

Reply—SAS No. 14 includes a statement of cash receipts and disbursements as a financial statement. Although a statement of cash receipts and disbursements is a summary of cash activity, it should not be confused with financial statements prepared

on the cash basis of accounting, which is a comprehensive basis of accounting that, among other things, prescribes classifying results of transactions as assets, liabilities, revenue, and expenses.

The following illustrates a report on a statement of cash receipts and disbursements.

We have examined the statement of cash receipts and disbursements of ABC Association for the years ended December 31, 19X2 and 19X1. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note X, the statement of cash receipts and disbursements is a summary of the cash activity of the Association and does not present transactions that would be included in financial statements of the Association presented on the accrual basis of accounting, as contemplated by generally accepted accounting principles. Accordingly, the accompanying statement is not intended to present financial position or results of operations in conformity with generally accepted accounting principles.

In our opinion, the accompanying statement presents fairly the cash receipts and disbursements of ABC Association for the years ended December 31, 19X2 and 19X1.

.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. 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. 14, *Special Reports*, paragraph 5, footnote 4, which amended SAS No. 1, section 544.04, *Lack of Conformity With Generally Accepted Accounting Principles*. In applying this paragraph, the auditor's report would take the following format:

- The first paragraph would be the standard scope paragraph.
- The second paragraph would be an explanation in full of the differences including the monetary effects in the accounting principles 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 third paragraph would be the qualified or adverse opinion regarding the application of GAAP.

- The fourth 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.

.09 State Accounting Guide Differs from GAAP

Inquiry—The guidelines stated in a State Department of Education accounting guide do not follow those stated in an AICPA Industry Audit Guide, *Audits of Colleges and Universities*. Are reports on financial statements conforming to the State accounting guide requirements considered special reports under SAS No. 14, *Special Reports*?

Reply—Yes. Reports on financial statements conforming to the State accounting guide requirements are considered special reports, under SAS No. 14. SAS No. 14, paragraph 4, 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. 14, paragraph 8, illustrates a special report for financial statements filed solely with the regulatory agency.

.10 Bank Directors' Examination

Inquiry—A CPA firm has been requested by the bank directors to perform specified examination procedures. One of the CPA firm's partners is a director of that bank. Can the firm acknowledge in its report that it is not independent and provide the above service?

Reply—No. The AICPA Industry Audit Guide, *Audits of Banks*, Appendix C, provides suggested guidelines for CPA participation in bank directors' examinations. Auditors performing agreed-upon procedures for this type of directors' examination must follow SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*. Paragraph 3, thereof, states that the general standards are applicable to these types of engagements; the second general standard requires the accountant to be independent. Further SAS No. 26, *Association With Financial*

Statements, paragraphs 9 and 10, states, "When an accountant is not independent, . . . any procedures he has performed should not be described." Accordingly, a CPA firm that is not independent of the bank cannot report on the procedures performed in this type of directors' examination.

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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.

.03 Reliance on Internal Auditors

Inquiry—An independent auditor examines the financial statements of a company which is one of five owned by a holding company. The largest company in the group has an internal audit staff which performs the internal audit function for all companies in the group. Although the internal audit department is separate from the accounting department and reports directly to the board of directors, it communicates with the accounting department regarding coordination of efforts. Consequently, the accounting department usually knows in advance the type and extent of procedures the internal audit staff will perform. How much reliance can the independent auditor place on the work of the Internal audit staff? For example, could confirmation requests be prepared and mailed under the independent auditor's control but be returned directly to the internal audit staff for follow up of exceptions and summarization of the test results? As another example, in this type situation, can an independent auditor use the internal audit staff for direct assistance in making his examination?

Reply—The independent auditor should review the competence and objectivity of internal auditors either while making a study and evaluation of internal accounting control or when using them to provide direct assistance. Paragraph 7 of Statement on Auditing Standards No. 9 states:

When considering the objectivity of internal auditors, the independent auditor should consider the organizational level to which internal auditors report, the results of their work and the organizational level to which they report administratively.

Assuming that the independent auditor believes the internal audit staff to be reasonably competent, the organizational and administrative position of the internal audit staff as described in the inquiry seems sufficient to assure the objectivity of internal auditors.

Even though the independent auditor may decide to rely on the work of the internal auditors, confirmation requests should be returned to the independent auditor. Paragraph 11 of SAS No. 9 indicates that the independent auditor must retain responsibility for judgments on audit matters such as the effectiveness of internal accounting control, the sufficiency of tests performed, the materiality of transactions, and other matters

affecting his report on the financial statements. Maintaining control over confirmation responses is an audit procedure that should be retained by the independent auditor because judgment on the significance of responses to confirmation requests must be made by the independent auditor. Consequently, the benefits of having the responses returned to the independent auditor far outweigh any additional costs that may be required. It would be acceptable, however, for the independent auditor's staff to list the confirmation responses and to delegate to the internal audit staff certain follow up inquiry procedures on exceptions that the independent auditor considers appropriate in view of the circumstances and the nature of the exceptions.

The independent auditor may use internal auditors to provide direct assistance in performing his examination as long as the internal audit staff is sufficiently objective.

.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—Interpretation No. 1, of SAS No. 2, "Report of an Outside Inventory-Taking Firm as an Alternative Procedure for Observing Inventories," especially paragraphs .05—.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.

.05 Non-Independent CPA Firm's Association With an Audit

Inquiry—May a CPA firm that is independent of a particular client allow another CPA firm that is not independent of the

same client to perform a portion of an audit for which the independent CPA firm is the principal auditor?

Reply—No. There is no standard which specifically allows a non-independent CPA firm to perform a portion of an audit. SAS No. 1, section 543, *Part of Examination Made by Other Independent Auditors*, gives guidance to principal auditors when part of the examination is performed by other independent auditors. It does not apply to a participating CPA firm that is not independent.

When a non-independent CPA firm functions as an internal auditor, the guidance in SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditors Examination*, should be followed. SAS No. 9 states, "The work of internal auditors cannot be substituted for the work of the independent auditor . . . judgments as to the effectiveness of internal accounting control, sufficiency of tests performed, materiality of transactions, and other matters affecting his report on the financial statements must be those of the independent auditor."

➤➤➤→ *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—Paragraphs 10—13 and 46—47 of Statement on Auditing Standards No. 2 indicate 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 indicate clearly in the scope paragraph (or in a separate 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. Paragraph 11 of SAS No. 2 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.

.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 paragraph 47 of Statement on Auditing Standards No. 2 is appropriate when the scope limitation precludes inventory observation and any other audit tests of the inventories.

The example shown in paragraph 47 is as follows:

(Scope paragraph)

. . . Except as set forth in the following paragraph, our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

(Separate paragraph)

The Company did not take a physical inventory of merchandise, stated at \$_____ in the accompanying financial statements as of December 31, 19XX, and at \$_____ as of December 31, 19XX. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19XX is no longer available. The Company's records do not permit the application of adequate alternative procedures regarding the inventories or the cost of property and equipment.

(Disclaimer paragraph)

Since the Company did not take physical inventories and we were unable to apply adequate alternative procedures regarding inventories and the cost of property and equipment, as noted in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

.06 Distinctions Between Scope Limitations

Inquiry—Paragraph 12 of Statement on Auditing Standards No. 2 states in part: "When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements."

Footnote 4 to paragraph 12 states: "Circumstances such as the timing of his work may make it impracticable or impossible for the auditor to accomplish these procedures. In such 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

➡ The next page is 10,955. ⬅

include 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 section 331.12 of SAS No. 1. Footnote 4 contemplates circumstances that are not related to any client-imposed restrictions, and are not within the control of either the client or the auditor.

Paragraph 11 of SAS No. 2 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 examined. 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 paragraph 11. Since section 331 of SAS No. 1 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.

.07 Inadequate Internal Controls and Financial Records

Inquiry—How should the auditor report that he has been unable, because of inadequate internal controls and financial records, to satisfy himself that all transactions were recorded?

Reply—Section 546.15 of SAS 1, states, in part:

Inadequate financial records or limitations imposed by the client may preclude the independent auditor from forming an opinion as to the consistent application of accounting principles between the current and the prior year, as well as to the amounts of assets or liabilities at the beginning of the current year.

Paragraph 10 of SAS 2 which deals with scope limitations, states, in part:

Restrictions on the scope of his examination, 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 2 if the effects of the inadequacy of internal control and the accounting records are sufficiently pervasive. Otherwise, a qualified opinion may be appropriate.

.08 Effects of Scope Limitation on Auditor's Opinion

Inquiry—Paragraphs 40, 46, and 47 of Statement on Auditing Standards No. 2 describe the form of report for an auditor in reporting on financial statements if the scope of the auditor's examination is limited. Do paragraphs 46 and 47 contradict 40?

Paragraph 46 states:

He should state that the scope of his examination was not sufficient to warrant the expression of an opinion.

Paragraph 47 states:

The scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

Paragraph 40 states:

Wording such as “In our opinion, except for the above-mentioned limitation on the scope of our examination . . .” bases the exception on the restriction itself, rather than on the possible effects on the financial statements, and therefore is unacceptable.

Reply—Paragraphs 46 and 47 do not contradict paragraph 40. The topic of paragraph 40 is the wording of a *qualified* opinion. A qualification should not be based on the restriction itself; a qualification should pertain to the possible effects on the financial statements. On the other hand, paragraphs 46 and 47 pertain to a *disclaimer of opinion* where the scope limitation itself does not permit the auditor to evaluate the possible effects on the financial statements.

.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, paragraph 6, 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.

Paragraph 7 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.

➡➡➡ *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. Paragraphs 39 and 41 of SSARS 1 are clear that the accountant must consider whether a modified report is adequate to disclose the departures. Paragraph 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—Appendix A of SSARS No. 1 lists certain suggested inquiries for a review engagement. Is a “yes” or “no” response sought?

Reply—Appendix A 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 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 . . .”

.03 Working Trial Balance

Inquiry—An accountant prepares the general ledger from information supplied by a client. He prepares, from the general ledger, monthly comparative trial balances on analysis paper for the client's use. The trial balance is classified as assets, liabilities, equity, sales, cost of sales, and expenses. Do the reporting requirements of SSARS No. 1 apply to such a trial balance?

Reply—The accounts in a general ledger are normally organized in the order that they appear in the financial statements. Consequently, a working trial balance would normally list debits and credits in that same order and under this condition would not be subject to the reporting requirements of SSARS No. 1. However, when the accountant adds captions to classify and provides sub-totals and/or totals for each classification, the working trial balance becomes a set of financial statements. Accordingly, the accountant should adhere to the reporting requirements of SSARS No. 1. [Amended]

.04 Financial Statements Marked As Unaudited

Inquiry—Should each page of compiled or reviewed financial statements be marked unaudited?

Reply—SSARS No. 1 does not require nor prohibit marking each page of compiled or reviewed financial statements of a nonpublic entity as unaudited. It does, however, require that each page of the financial statements should include a reference such as "See Accountant's Compilation Report" or "See Accountant's Review Report," as appropriate.

SAS No. 26, paragraph 5, requires that each page of unaudited financial statements of a public entity should be clearly and conspicuously marked as unaudited.

.06 Disclosure for Compiled or Reviewed Financial Statements Prepared on a Comprehensive Basis of Accounting Other than GAAP

Inquiry—What constitutes adequate disclosure in compiled or reviewed financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles?

Reply—Whether an accountant or auditor is reporting on compiled, reviewed, or audited financial statements, he should

use the same criteria to evaluate disclosure. An Auditing Interpretation, "Adequacy of Disclosure in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles *," states in part:

In addition, when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, the same degree of informative disclosures is generally appropriate. For example, financial statements prepared on an income tax basis or a modified cash basis of accounting usually reflect depreciation, long-term debt and owners' equity. Thus, the informative disclosures for depreciation, long-term debt and owners' equity in such financial statements should be comparable to those in financial statements prepared in conformity with generally accepted accounting principles.

.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 No. 1, paragraph 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 changes in financial position. 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 No. 1, paragraph 4, it does not meet the definition of a financial statement, and therefore, the accountant does not have a report-

* See *AICPA Professional Standards*, Volume 1, AU section 9621.34—.39.

ing obligation. However, the accountant may want to issue a report to clarify his responsibility. This can be done by modifying the standard compilation report (SSARS No. 1, paragraph 17) to refer to the schedules. [Amended]

.09 Application of SSARS No. 3 to Certain Companies Required to File with Regulatory Bodies

Inquiry—Some nonpublic entities, as defined in SSARS No. 2, paragraph 1, 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 No. 3, paragraph 2, preclude an accountant from using the alternative form of report illustrated in SSARS No. 3 in those circumstances?

Reply—No. SSARS No. 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 No. 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 No. 3, 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. 14, *Special Reports*, paragraph 4), but SSARS No. 1, *Compilation and Review of Financial Statements*, reporting standards would apply, not those in SSARS No. 3. SSARS No. 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 No. 1 would be appropriate provided that, as required by SSARS No. 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 the financial statements are received in the client's office directly from the computer, the firm does not have a reporting responsibility. However, if the firm inputs the data or the financial statements are generated in the firm's office, there is a reporting responsibility as discussed in SSARS No. 1, *Compilation and Review of Financial Statements*, paragraph 7.

.12 Interim Cash Basis Statements and Year-End Accrual Basis Statements

Inquiry—The client wants computer generated monthly compiled cash basis financial statements and annual reviewed accrual basis financial statements. The monthly statements will be based upon cash receipts and disbursements without recognizing accrual, prepayments and inventory adjustments. Can the accountant state in the monthly reports that the monthly financial statements were prepared on a cash basis and the annual financial statements will be prepared on an accrual basis?

Reply—SSARS No. 1, *Compilation and Review of Financial Statements*, paragraph 20, states that “if financial statements compiled in conformity with a comprehensive basis of accounting other than generally accepted accounting principles do not include disclosure of the basis of accounting used, the basis should be disclosed in the accountant’s report.”

Consequently, if the basis of presentation is disclosed in the monthly cash basis financial statements the accountant’s report need not be modified.

The fact that year end financial statements will be prepared on the accrual basis should not be mentioned in the accountant’s compilation report for the interim periods. However, the client can make that statement in a transmittal letter when he sends the interim financial statements to third parties.

.13 Compiled or Reviewed Financial Statements Prepared on the Liquidation Basis

Inquiry—Can compiled or reviewed financial statements prepared on a liquidation basis be considered in accordance with generally accepted accounting principles? Would the financial statement format be similar to a going concern basis?

Reply—Yes. APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, paragraph 117, footnote 25, states in part, “if liquidation appears imminent, financial information may be prepared on the assumption that liquidation will occur.” Therefore, the liquidation basis of accounting may be considered to be generally accepted accounting principles for entities in which liquidation appears imminent. In such circumstances, the client ordinarily should include an explanatory paragraph in the footnotes that states that the entity has changed the basis of ac-

counting used to determine the amounts at which assets and liabilities are carried from the going concern basis to liquidation basis. If the client omits substantially all disclosures the accountant's report should include such an explanatory paragraph which is required by SSARS 1, *Compilation and Review of Financial Statements*, paragraph 40, footnote 14.

No. The financial statement format would be different for a company in liquidation. Drawing from sample auditor's reports in Interpretation No. 8 of SAS No. 2, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting," it appears that the statements of income, retained earnings, and changes in financial position are presented for the period before the company has decided to liquidate. A statement of changes in net assets would be presented for the period the company was in liquidation.

.14 Uncertainties/Going-Concern Problems

Inquiry—SAS No. 34, *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence*, provides guidance on that subject as it would affect an auditor's opinion under SAS No. 2, *Reports on Audited Financial Statements*. 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 14, 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. Footnote 14 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, "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.

.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*. SAS No. 1, section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph 10, 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 opinion as to consistency. How is this consistency issue treated in compilation and review engagements?

Reply—SSARS 1, *Compilation and Review of Financial Statements*, footnote 14, 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 inconsistency in a footnote to the financial statements would satisfy this requirement. Footnote 14 further states, “nothing in this statement, however, is intended to preclude an accountant from emphasizing in a separate paragraph of his report a matter regarding the financial statements.”

.16 Reference to Accountant's Report in Notes to Financial Statements

Inquiry—SSARS 1, *Compilation and Review of Financial Statements*, paragraphs 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.

.17 Modification of Compilation Report on Prospective Financial Statements

Inquiry—Company A requests that an accountant compile a prospective financial statement (either a forecast or a projection) in which depreciation is calculated based on an accelerated method. It is anticipated that the straight-line method of depreciation will be used for the actual historical financial statements for the prospective period. The company does not disclose the fact that different accounting principles will be used or the effects on the financial position and results of operations. May an accountant accept this engagement?

Reply—Yes. According to the *Guide for Prospective Financial Statements*, section 620, paragraph .09, an accountant may compile prospective financial statements that omit disclosures other than those relating to significant assumptions provided the omission is not undertaken, to the accountant's knowledge, with the intention of misleading the users of the statements. The accountant would be required to indicate the different depreciation methods to be used in his compilation report.

.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, 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, 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 an engagement, as required by Rule 201(D) of the Rules of Conduct of the AICPA Code of Professional Ethics. (See SSARS 1, paragraph 3.) [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*, 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, 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.

.21 Income Taxes Omitted on Interim Financial Statements

Inquiry—The management of a Subchapter C corporate client have rationalized that there will be no income tax due by year end because they will pay year-end bonuses, pension contributions and/or purchase property and equipment to obtain accelerated depreciation deductions. Accordingly, its interim financial statements are prepared without a provision and estimated liability for income taxes.

- (1) Is this in conformity with generally accepted accounting principles?
- (2) How should the accountant's compilation report be presented?

Reply—(1) No. APB Opinion No. 28, *Interim Financial Reporting*, paragraph 17, states:

The amounts of certain costs and expenses are frequently subjected to year-end adjustments even though they can be reasonably approximated at interim dates. To the extent possible such adjustments should be estimated and the estimated costs and expenses assigned to interim periods so that the interim periods bear a reasonable portion of the anticipated annual amount. Examples of such items include inventory shrinkage, allowance for uncollectible accounts, allowance for quantity discounts, and discretionary year-end bonuses.

In addition the last sentence of footnote 7 of FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, states:

If an enterprise is unable to estimate a part of its "ordinary" income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

Accordingly, where year-end bonuses ("ordinary" income) have not been estimated and included in the interim period, because the estimate is not reliable, then the tax benefit should be recorded in the period that the estimate (or actual) expense is reported in the financial statements.

(2) Following is an example of an accountant's compilation report that would cover this departure from generally accepted accounting principles:

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the

year then ended, in accordance with standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. 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. However, we did become aware of certain departures from generally accepted accounting principles that are described in the following paragraph.

It is management's intent to minimize or eliminate income taxes by paying year-end bonuses, pension contributions and/or purchasing property and equipment to obtain accelerated depreciation deductions. None of these potential transactions have been estimated, nor has a provision for income taxes been reported in the accompanying financial statements. Generally accepted accounting principles require that discretionary year-end bonuses and/or pension costs should be estimated and assigned to interim periods so that the interim periods bear a reasonable portion of the anticipated annual amount. If these amounts cannot be reliably estimated then the tax consequence should be reported in the interim period in which the item is reported.

➡➡➡ *The next page is 11,301.* ⬅⬅⬅

Section 9900

Other Reporting Problems

.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, 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]

.04 Use of "Accountants' Report" for a Disclaimer of Opinion

Inquiry—Can "Accountants' Report" be used as the title for a disclaimer of opinion?

Reply—The title, "Accountants' Report," can be used as the title for a disclaimer of opinion because a disclaimer of opinion is a type of report.

.05 Divisional Financial Statements

Inquiry—Does an auditor's responsibility when reporting on a division's financial statements differ from the responsibility the auditor has when reporting on the financial statements of the entity taken as a whole?

Reply—There is no difference between the auditor's responsibility for reporting on a division's financial statements and the responsibility for reporting on the financial statements of the entity taken as a whole. The auditor would usually identify the division as a component of a larger business enterprise.

.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 No. 1, 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.

TIS

APPENDIXES

References cited in the Technical Information Service Inquiries and Replies are cross-indexed to sections in the text

TABLE OF CONTENTS

Index of References

	Page
American Institute of Certified Public Accountants	
Accounting Research Bulletins	15,011
Accounting Principles Board Opinions	15,021
Accounting Principles Board Statements	15,031
Accounting Interpretations of APB Opinions	15,041
Accounting Research Studies	15,051
Accounting Terminology Bulletins	15,055
Statements of Position	15,065
Statements on Auditing Standards	15,071
Statement on Standards for Accountants' Services on Prospective Financial Information	15,075
Auditing Interpretations of Statements on Auditing Standards	15,081
Audit and Accounting Guides	15,091
Statements on Standards for Accounting and Review Services	15,095
Accounting and Review Services Interpretations	15,095-3
Notices to Practitioners	15,097
Securities and Exchange Commission	
SEC Regulation S-X	15,101
Securities and Exchange Act Releases	15,101
Codification of Financial Reporting Policies	15,101
Staff Accounting Bulletins	15,101
Industry Guides	15,101
Financial Accounting Standards Board	
FASB Statements of Financial Accounting Concepts	15,111
FASB Statements of Financial Accounting Standards	15,115
FASB Interpretations	15,121
FASB Technical Bulletins	15,133
Governmental Accounting Standards Board	
GASB Codification	15,139
National Council on Governmental Accounting	
NCGA Statements	15,143

➡ The next page is 15,011. ⬅

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Accounting Research Bulletins

No.	Chap.	Par.	Sec.	No.	Chap.	Par.	Sec.
43	1A	4	2260.01	43	7B	10	4150.02
	1B		4120.02		7B	10	4150.03
	2A	2	1100.01		7B	12	4150.01
	3A		2240.05		7B	12	4150.03
	3A	4	2120.03		7B	13	4150.02
	3A	4	2130.02		9C	9	5210.08
	3A	4	2140.13		11A		5100.28
	3A	6	2120.01		11A	13	6700.05
	3A	6	2230.02		11A	16	6700.05
	3A	6	2240.01		11A	17	6700.05
	3A	7	2240.01		11A	18	6700.05
	3A	9	2120.03		12	8	1400.01
	4	3	2140.03		13B	12	4140.05
	4	3	2140.04	45		1	6700.05
	4	5	2140.01			6	5260.01
	4	6	2140.09			11	5260.01
	4	7	2140.09	46			4220.02
	4	8	2140.12	51			6400.02
	4	8	7300.12			1	1400.01
	4	9	7300.12			2	1400.01
	4	11	3500.04			2	1400.15
	4	16	2140.06			4	1400.22
	4	16	2140.08			6	1400.08
	4	17	3500.04			6	1400.09
	7A		4220.01			15	1400.21
	7A		4220.02			17	1400.08
	7A		4220.03			22	1400.06
	7A	9	4220.03			22	1400.18
	7B	10	4150.01			24	9410.05

➡ The next page is 15,021. ⬅

Accounting Principles Board Opinions

No.	Par.	Sec.	No.	Par.	Sec.
1	...	5210.07	15	6	5500.02
	...	9210.10		22	5500.14
6	...	6610.03		23	5500.14
	12	4120.02		36	5500.09
	17	2210.18		36	5500.11
	17	2250.04		36	5500.12
	17	4220.01		37	5500.09
8	27	5230.03		38	5500.09
	30	5230.03		38	5500.14
	41	5230.07		38	5500.16
10	7	1100.11		40	5500.14
	7	2240.01		48	5500.15
11	...	2130.04		50	5500.07
	...	2210.19		51	5500.09
	...	5210.07		52	5500.09
	...	5400.03		53	5500.09
	...	7910.04		57	5500.12
	13	6100.04		58	5500.09
	13	7200.03		62	5500.05
	33	5220.06		64	5500.05
	36	5250.13		65	5500.10
	45	5250.13		70	4210.02
	46	5250.13			
	47	5250.13	16	...	5250.06
	48	5250.13		...	6110.02
	49	5250.06		...	6110.03
	57	2130.02		...	6110.04
	57	5250.01		...	7600.07
	57	5250.02		...	7610.19
	61	5250.05		5	7610.18
	63	9310.02		5	7620.04
				5	7620.05
Appendix A (D)		5210.02		5	7620.06
12	...	5210.02		5	7620.07
	5	9410.03		5	7620.08
	6	5230.06		5	7620.12
	7	5230.06		43	7610.18
	8	5230.06		43	7620.06
	16	3200.10		46	7600.01
	16	5100.31		46	7620.09
	17	3200.10		46	7620.10
	17	5100.31			

Accounting Principles Board Opinions—(Cont'd)

No.	Par.	Sec.	No.	Par.	Sec.
16	47	7600.02	16	90	7610.09
	47	7600.04		91	7610.07
	47	7620.05		91	7610.08
	47	7620.10		91	7610.09
	47	7620.11		91	7610.18
	47	7620.13		92	7610.09
	47	7620.14		93	7610.01
	47	7620.16		93	7610.02
	47	7630.01		94	7610.02
	48	7620.15		99	7620.01
	53	7600.06	17	...	6200.03
	53	7630.02		...	7610.04
	58	7600.05		...	7610.05
	66	7610.06		...	7610.18
	67	2210.21		22	2210.13
	67	7610.15		24	4110.02
	68	7610.09		24	4110.04
	68	7610.15		25	2250.04
	76	7600.05		25	4110.02
	80	2250.02		26	4110.02
	87	7610.06		27	7610.06
	87	7610.07		28	7610.06
	87	7610.09		29	7610.06
	87	7610.13		30	2250.02
	87	7610.19		30	7610.06
	88	2220.08		31	2250.02
	88	6110.03		31	3200.06
	88	7600.01		31	7610.06
	88	7610.06	18	2	2220.07
	88	7610.07		2	7300.05
	88	7610.08		3	2220.03
	88	7610.09		3	2220.06
	88	7610.10		4	1400.01
	88	7610.12		14	1400.01
	88	7610.15		14	1400.05
	88	7610.19		14	1400.14
	89	6110.03		14	7610.06
	89	7610.06		14	9410.05
	89	7610.07		17	2220.01
	89	7610.09		17	7300.05
	89	7610.12			

Accounting Principles Board Opinions—(Cont'd)

No.	Par.	Sec.	No.	Par.	Sec.
18	17	7620.03	20	17	9210.05
	19	2220.05		18	9210.01
	19	2220.08		19	5210.01
	19	2220.10		19	9210.05
	19	2220.11		20	1300.08
	19	2220.12		20	5210.01
	19	2220.13		20	9210.05
	19	7600.06		21	5210.01
	19	7920.01		21	9210.05
19	...	1300.01		22	5210.01
	...	1300.11		24	5210.01
	...	6610.02		29	9210.02
	7	1300.03		31	2250.02
	7	1300.05		31	6400.09
	7	1300.07		31	9210.08
	7	1300.10		32	6400.09
	8	1300.02		32	9210.08
	9	6610.01		33	6400.09
	10	1300.06		33	9210.08
	10	1300.08		...	3200.06
	11	6610.01		...	6960.05
	12	1300.02		...	7400.06
	12	1300.04		2	2130.06
	14	1300.09		2	5100.31
	15	1300.02		2	5220.06
20	...	1200.03		3	2130.06
	...	2240.04		3	5220.04
	...	3200.06		3	6130.01
	...	6130.07		15	3200.10
	...	7300.17		15	5100.31
	...	7600.05		15	5220.05
	...	9210.03		15	6110.03
	...	9210.04		16	3200.01
	...	9210.10		16	3200.02
	6	9210.08		16	3200.03
	7	9210.05		16	3200.04
	8	2220.13		16	6130.01
	10	6400.09		22	8
	10	9210.08		23	2
	11	6400.09		12	7920.01
	11	9210.08		23	9210.06
	13	9210.05			

Accounting Principles Board Opinions— (Cont'd)

No.	Par.	Sec.	No.	Par.	Sec.
25	8	7200.06	30	13	5400.01
	10	4140.01		14	7920.01
	10	4140.02		19	5400.02
	13	4140.01		19	6400.09
	14	4110.05		20	4110.04
	20	4140.04		20	5400.01
26	...	3200.06		20	5400.02
	...	4160.02		20	5400.04
	20	4160.02		20	6100.06
28	17	9600.21		20	6400.09
29	...	2210.21		21	5400.02
	...	6110.09		21	6400.09
	18	2210.11		22	5400.02
	20	6110.09		22	6400.09
	21	6600.07		23	2250.05
30	...	5100.29		23	5400.03
	...	5250.05		23	6400.09
	8	1200.02		26	2250.05
	10	5400.03		26	4110.04
	11	5400.03		26	5400.01
	12	5400.03		26	5400.02
	13	1200.02		26	5400.04
				26	6100.06

➡ *The next page is 15,031.* ←

Accounting Principles Board Statements

No.	Par.	Sec.	No.	Par.	Sec.
4	...	7600.08	4	152	5100.27
	117	9600.13		153	5100.27
	148	5100.16		199	3400.02
	150	5100.27	6	182	7600.08
	151	5100.27			

➡ *The next page is 15,041.* ←

Accounting Interpretations of APB Opinions

Opinion No.	Interp. No.	Sec.	Opinion No.	Interp. No.	Sec.
8	13	5230.03	16	30	7620.13
11	11	5250.03		33	6410.03
	16	5250.06		33	7600.05
12	1	2240.05		39	7600.06
15	Introduction	5500.09		39	7600.07
	10	5500.16		39	7600.08
	21	5500.07		39	7620.03
	25	5500.08		39	7620.04
	64	5500.03		39	7620.05
	80	5500.03		39	7620.06
	91	5500.05		39	7620.07
16	4	7600.04		39	7620.12
	14	7620.13	18	1	2220.08
	20	7610.01		1	2220.10
	20	7620.11		2	2220.05
	20	7620.16		2	2220.06
	21	7620.15		2	2220.11
	26	7610.18	30	1	1200.02

➡ The next page is 15,051. ←

Accounting Research Studies

No.	Page	Sec.	No.	Page	Sec.
7	203	3500.06	15	23	4110.07
	257	1100.06		67-68	4230.01
15		4220.02			

➡ *The next page is 15,055.* ⬅

Accounting Terminology Bulletins

No.	Par.	Sec.
1	69(4)	3500.06

➡ *The next page is 15,065.* ←

Statements of Position

No.	Title	Sec.
74-12	<i>Accounting Practices in the Mortgage Banking Industry</i>	6110.05
75-2	<i>Accounting Practices of Real Estate Investment Trusts</i>	6110.10
76-2	<i>Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry</i>	6110.05
76-3	<i>Accounting Practices for Certain Employee Stock Ownership Plans</i>	4140.06
78-9	<i>Accounting for Investments in Real Estate Ventures</i>	1400.19 2220.05 2220.12 6110.10
78-10	<i>Accounting Principles and Reporting Practices for Certain Nonprofit Organizations</i>	1300.07 2210.23 7300.07 7300.17
81-1	<i>Accounting for Performance of Construction-Type and Certain Production-Type Contracts</i>	6700.01
82-1	<i>Accounting and Financial Reporting for Personal Financial Statements</i>	1600.02

➤➤➤→ The next page is 15,071. ←➤➤➤

Statements on Auditing Standards

No.	Sec.	Par.	Sec.	No.	Sec.	Par.	Sec.
1	110	.02	9410.06	1	530	.01	9430.03
	331	...	8340.13		542	.05	9410.04
		.01	8320.02		543	...	9510.03
		.02	8320.02		543	...	9520.05
		.03	8320.02		544	.04	9510.08
		.03	8340.01		546	.15	9530.07
		.04	8320.02		560	.03	3100.04
		.04	8340.01			.03	9330.01
		.05	8320.02			.03	9330.03
		.05	8340.01			.04	9330.03
		.05	8340.13			.05	9330.01
		.06	8320.02			.07	9330.02
		.06	8340.01		901	.12	9430.03
		.07	8320.02			.13	1100.12
		.07	8340.01			.24	8320.06
		.08	8320.02			.25	8320.06
		.08	8340.01			.26	8320.06
		.09	2140.02			.27	8320.06
		.09	8320.01	2		.28	8320.06
		.09	8320.02			...	2210.09
		.09	8320.05			...	9410.13
		.10	2140.02			...	9600.14
		.10	8320.01			5	1100.01
		.10	8320.05			5	9410.03
		.11	2140.02			7	1500.05
		.11	8320.01			7	9410.09
		.11	8320.05			10	8320.02
		.12	2140.02			10	9530.01
		.12	8320.01			10	9530.07
		.12	8320.05			11	8320.02
		.12	9530.06			11	9530.01
		.13	2140.02			11	9530.06
		.13	8320.05			12	8320.02
		.14	8320.05			12	8340.02
		.14	8320.06			12	9530.01
		.15	8320.05			12	9530.06
	332	.05	2220.11			13	1100.01
	420	...	9210.04			13	8320.02
		.06	5210.01			13	9410.03
		.07	9210.09			13	9410.04
		.08	9210.09			13	9530.01
		.09	9210.09			15	1500.05
		.10	9600.15			16	1500.05
		.14	1100.13			17	1500.05
						21	6110.09
						21	9320.05

Statements on Auditing Standards—(Cont'd)

No.	Sec.	Par.	Sec.	No.	Sec.	Par.	Sec.
2		21	9320.07	14		4	9510.09
		22	9320.05			4	9600.10
		22	9320.07			5	9510.08
		23	6400.08			7	1300.10
		23	9320.05			7	1500.04
		23	9320.07			8	1500.04
		24	6400.08			8	6950.03
		24	9320.03			8	9320.08
		24	9320.05			8	9510.09
		24	9320.07	15		2	9430.01
		25	6400.08	16		10	8900.04
		25	9320.02	19		...	8900.03
		25	9320.05	22		...	8220.04
		25	9320.07	26		5	9600.04
		26	9320.05			9	9510.10
		26	9320.07			10	9510.10
		35	9320.05			15	9900.03
		40	9530.08	29		...	6100.01
		45	9310.01			6	9410.12
		46	9530.01			6	9410.14
		46	9530.08			13	9410.12
		46	9550.02	30		...	9110.05
		47	9530.01			...	9110.07
		47	9530.02			3	9110.07
		47	9530.08			4	9110.07
5		7	7300.17			5	9110.07
7		...	8900.02			6	9110.07
		...	8900.05			7	9110.07
		...	9520.05			8	9110.07
		4	8900.05			9	9110.07
9		7	9520.03			10	9110.07
		11	9520.03			11	9110.07
12		...	8340.09			12	9110.07
		...	8340.10			13	9110.07
		6	9530.09			14	9110.07
		7	9530.09			15	9110.07
		Appen- dix A	8340.12			16	9110.07
14		...	9320.08			17	9110.07
		...	9510.07			18	9110.07
		...	9510.09			19	9110.07
		4	1500.03			20	9110.07
		4	1500.05			21	9110.07
						22	9110.07
						23	9110.07

Statements on Auditing Standards—(Cont'd)

No.	Sec.	Par.	Sec.	No.	Sec.	Par.	Sec.
30		24	9110.07	39		...	8220.05
		25	9110.07			1	8220.01
		26	9110.07			15	8220.01
		27	9110.07			16	8220.01
		28	9110.07			17	8220.01
		29	9110.07			18	8220.01
		30	9110.07			18	8220.02
		31	9110.07			19	8220.01
		32	9110.07			20	8220.01
		33	9110.07			21	8220.01
		34	9110.07			21	8220.02
		35	9110.07			22	8220.01
		36	9110.07			22	8220.02
		37	9110.07			23	8220.01
		38	9110.07			23	8220.03
		39	9110.07			24	8220.01
		40	9110.07			24	8220.02
		41	9110.07			25	8220.01
		42	9110.07			25	8220.02
		43	9110.07			26	8220.01
		44	9110.07			26	8220.02
		45	9110.07			27	8220.01
		46	9110.07			28	8220.01
		47	9110.07			29	8220.01
		48	9110.07			30	8220.01
		49	9110.07			30	8220.02
		50	9110.07			31	8220.01
		51	9110.07			32	8220.01
		52	9110.07			33	8220.01
		53	9110.07			34	8220.01
		54	9110.05			35	8220.01
		55	9110.05			36	8220.01
		56	9110.05			37	8220.01
		57	9110.05			38	8220.01
		58	9110.05			39	8220.01
		59	9110.05			40	8220.01
31		...	8310.02			41	8220.01
32		...	3500.06			42	8220.01
		...	6100.10			43	8220.01
34		...	9600.14			44	8220.01
		11	9390.05			45	8220.01
35		...	9510.10			...	8220.04
		3	9510.10	41		...	9410.15
39		...	8220.01	42		7	7300.17
		...	8220.02	43		...	8320.06
		...	8220.03			...	6100.08
		...	8220.04	45		...	

➡ The next page is 15,075. ⬅

**Statement on Standards for Accountants' Services on
Prospective Financial Information**

Sec.	Par.	Sec.
2100	Appendix A	1700.01

➡ The next page is 15,081. ⬅

Auditing Interpretations of Statements on Auditing Standards

Auditing Interpretation AU Sec.*	TIS Sec.
9332.13	6610.01
9337.06—.07	8340.12
9337.13	8340.12
9509.01—.06	9520.04
9509.33—.38	9600.13
9621.34—.39	9320.08
9621.34—.39	9600.06

➡ The next page is 15,091. ←

* See Volume 1, *AICPA Professional Standards*.

Audit and Accounting Guides

Name of Guide	Sec.	Name of Guide	Sec.
<i>Audits of Banks</i>	5100.30		6130.06
	6100.04		6130.07
	6100.07		8340.01
	6100.08		
	9510.10	<i>Audits of Investment Companies</i>	2220.07
<i>Audits of Brokers and Dealers in Securities</i>	1100.02		6910.01
	6980.01		6910.03
	8340.05	<i>Audits of State and Local Governmental Units</i>	1300.07
	9110.05		6400.12
	9110.07		6950.03
<i>Audits of Certain Nonprofit Organizations</i>	7300.17		6950.05
			6950.07
<i>Audits of Colleges and Universities</i>			6950.08
	1300.07		6950.10
	5100.30		6950.12
	6960.01		9110.06
	6960.02	<i>Audits of Voluntary Health and Welfare Organizations</i>	1300.07
	6960.03		6920.03
	6960.04		6920.04
	6960.05		6920.07
	6960.06		6920.08
	6960.07		6920.09
	6960.09		7300.07
	6960.11		7300.09
	6960.12	<i>Construction Contractors</i>	6700.01
	7300.13	<i>Guide for Prospective Financial Statements</i>	9600.17
	9510.09	<i>Hospital Audit Guide</i>	1300.07
<i>Audits of Credit Unions</i>	6120.01		2210.16
	6120.02		6400.01
<i>Audits of Employee Benefit Plans</i>			6400.02
	6930.02		6400.03
	6930.03		6400.06
<i>Audits of Finance Companies</i>			6400.09
	6130.02		6400.10
	6130.03		6400.11
	6130.04		6400.12
	6130.05		

Audit and Accounting Guides—(Cont'd)

Name of Guide	Sec.
<i>Savings and Loan</i>	6110.03
<i>Associations</i>	6110.05
	6110.06
	6110.08
	6110.10

➡ The next page is 15,095. ←

Statements on Standards for Accounting and Review Services

No.	Par.	Sec.
1	...	9600.03
	...	9600.04
	...	9600.10
	...	9600.19
	3	9600.18
	4	9600.08
	7	9600.11
	11	9600.18
	16	9600.16
	17	9600.08
	20	9600.12
	34	9600.16
	39	9600.01
	40	9600.01
	40	9600.10
	40	9600.13
	40	9600.14
	40	9600.15
	40	9900.06
	41	9600.01
	43	9410.14
	43	9600.08
2	Appendix A	9600.02
	...	9600.10
	1	9600.09
	8	9600.20
	12	9600.20
3	...	9600.09
	...	9600.10
	1	9600.10
	2	9600.09
	3	9600.10

➡ The next page is 15,095-3. ⬅

Accounting and Review Services Interpretations

SSARS No.	Interp. No.	Sec.
1	3	9600.19

➡ *The next page is 15,097.* ←

Notices to Practitioners**Accounting**

Issue Date	Title	Sec.
3/10/80	<i>Savings and Loan Committee Provides Guidance on Fee Regulations</i>	6110.08*
11/23/81	<i>AcSEC Position on Tax Act and Depreciable Lives</i>	5210.07
1/11/82	<i>AcSEC Position on Accounting for Combinations of Mutual Savings and Loan Associations or Mutual Savings Banks</i>	6110.02—.04
9/13/82	<i>AcSEC Position on Accounting by Colleges and Universities for Compensated Absences</i>	6960.11.
6/27/83	<i>Guidance Offered on Mortgage Banking Activities</i>	6110.05
10/10/83	<i>Savings and Loan Costs</i>	6110.06
12/26/83	<i>Views on Bank Loan Disclosures</i>	6100.10
1/23/84	<i>Statement by the AICPA Insurance Companies Committee</i>	6300.06
9/24/84	<i>Deposit Float</i>	6100.11
9/24/84	<i>Loan Origination Fees</i>	6110.08
5/27/85	<i>Accounting for Foreign Loan Swaps</i>	6100.12
2/10/86	<i>Acquisition, Development and Construction Arrangements</i>	6110.10

Auditing

8/83	<i>Audit Sampling Implementation— Questions and Answers</i>	8220.01—.05
12/12/83	<i>Statement by AICPA Banking Committee</i>	6100.08
2/11/85	<i>Statement by the AICPA's Auditing Standards Division</i>	6110.09

➡ The next page is 15,101. ←

*This notice was added to by the Notice to Practitioner issued 9/24/84 *Loan Origination Fees*.

SECURITIES AND EXCHANGE COMMISSION

Regulation S-X

Sec.
210.5-2.28

TIS Sec.
4110.08

Securities and Exchange Act Releases

No.
9000

TIS Sec.
1100.01

Codification of Financial Reporting Policies

Sec.	TIS Sec.	Sec.	TIS Sec.
201.02	7620.11	404.03.b. iv.	6910.03
210	4220.01	404.04.a	2220.09
210	4220.03		

Staff Accounting Bulletins

No.	Topic	TIS Sec.
49A	11H	6100.10

Industry Guides

No.	Title	TIS Sec.
3	<i>Statistical Disclosure by Bank Holding Companies</i>	6100.10

➡➡➡→ *The next page is 15,111.* ←➡➡➡

FINANCIAL ACCOUNTING STANDARDS BOARD
FASB Statements of Financial Accounting Concepts

No.	Par.	Sec.
3	...	2210.15
	...	6960.11
4	...	7300.17
5	83	5100.14
	83	5100.23
	83	5100.25
	83	6600.01
	84	3600.01
	84	5100.09
	84	5100.14
	84	5100.23
	84	6600.01
6	62	4110.08

➤ *The next page is 15,115.* ←

FINANCIAL ACCOUNTING STANDARDS BOARD
FASB Statements of Financial Accounting Standards

No.	Par.	Sec.
2	...	5240.03
	...	5240.04
4	...	3200.06
5	...	3500.06
	...	6100.10
	...	8340.12
	18	3500.05
	19	3500.05
	44	6300.06
7	...	5240.03
	...	5240.08
	8	5240.06
	10	5240.08
12	...	6120.02
	5	1600.01
	7	2120.04
	8	2120.04
	12	2120.03
13	...	1500.05
	5	2210.24
	7	5600.02
	10	2210.24
	10	3200.10
	12	3200.10
	15	5600.03
	20	5600.01
	31	1400.18
14	...	7920.03
	...	9390.05
15	...	6100.10
	13	5100.29
	14	5100.29
	21	5100.29
16	...	1200.03
	...	9600.15
	16a	1300.11
21	...	1700.01
	9	9390.05
32	...	7300.17
34	...	6110.06
	...	6110.10
	13	2210.20
	57	2210.20
35	11	6935.02
	14	6935.02
37	4	2130.02
	4	5250.01
	4	5250.02

FINANCIAL ACCOUNTING STANDARDS BOARD
FASB Statements of Financial Accounting Standards—(Cont'd)

No.	Par.	Sec.
43	...	6960.11
	6	9320.10
45	5	6940.01
	8	6940.01
	17	6940.01
57	...	5220.06
	...	7400.04
	...	7400.05
	2	7400.04
	3	7600.08
58	...	6110.10
60	9	6300.07
	40	6300.06
	60f	6300.06
65	...	6110.05
	39	6110.05
	45	6110.05
66	...	3200.07
	...	6110.10
	5	6600.04
	10	6600.08
	15	6600.04
	26	6600.03
	37	6600.02
67	...	6110.10
	...	6610.02
	11	6610.04
	18	6610.02
68	9	5240.02
	10	5240.02
71	...	6200.01
	9	6200.01
72	...	6110.03
	5	6110.03
	6	6110.03
	7	6110.03
77	...	5600.01
	5	2130.04
	Appendix B	2130.04
78	...	1100.09
	...	9410.13

➡ The next page is 15,121. ⬅

FINANCIAL ACCOUNTING STANDARDS BOARD
FASB Interpretations

No.	Par.	Sec.
6	4	5240.07
9	...	6110.03
18	8	9600.21

➡➡➡→ *The next page is 15,133.* ←➡➡➡

FINANCIAL ACCOUNTING STANDARDS BOARD**FASB Technical Bulletins**

No.	Par.	Sec.
83-1	...	2210.19
85-3	...	5600.03

➡➡➡ *The next page is 15,139.* ←←←

**GOVERNMENTAL ACCOUNTING STANDARDS
BOARD****GASB Codification**

Sec.	Par.	Sec.
1600	.106	6950.08
G60	.116	6950.12

➡ *The next page is 15,143.* ←

**NATIONAL COUNCIL ON GOVERNMENTAL
ACCOUNTING****NCGA Statements**

No.	Par.	Sec.
4	22	9320.07

TIS TOPICAL INDEX

TECHNICAL INFORMATION SERVICE

INQUIRIES AND REPLIES

References are to section numbers.

ACCELERATED COST RECOVERY SYSTEM

- Financial Reporting, Relation to 2210.19; 5210.07
- Relation to Generally Accepted Accounting Principles 5210.07

ACCOUNTING CHANGES

- Accounting Principles 2220.13; 9210.02; 9210.05; 9600.15
- Allowance for Uncollectible Accounts 9210.08
- Change from Comprehensive Basis of Accounting to GAAP 9600.15
- Change from GAAP to Comprehensive Basis of Accounting 9210.10
- Change in Amortization Method 5220.05
- Consistency 9210.09
- Depreciable Life 2250.02; 9210.03
- Depreciation Method 1300.08; 5210.01; 6920.08
- Discounts on Long-term Loans 6130.07
- Estimates 1200.03; 2250.02; 3200.06; 6400.09; 9210.03
- Fiscal Year Change 9210.04
- Going Public 9210.02
- Goodwill Write-off 2250.05
- Income Statement Presentation 9210.01
- Insurance Reimbursements 6400.09
- Legal Transactions 9210.09
- Merger Costs Capitalized 7600.05
- Overhead Application Method 9210.05
- Premiums on Life Insurance 2240.04
- Reclassification of Assets 2210.12
- Refinanced Debt 3200.06
- Reporting Entity 9210.09
- Restated Financial Statements 9210.01—.02
- Statement of Changes in Financial Position 1300.08
- vs. Change in Circumstances 2220.13

ACCOUNTING POLICIES

- Bank Deposit Float 6100.11
- Foreign Loan Swaps 6100.12
- Inventory Cost Methods 9410.12
- Nonprofit Organizations 7300.17
- Profit Sharing Plan Statements 6935.01
- Receivables Transferred to Bank 2130.04
- Relation to Financial Statements 9600.08
- Revenue Recognition 5100.25

ACCOUNTING PRINCIPLES—See Generally Accepted Accounting Principles

ACCOUNTS RECEIVABLE—See Receivables

ACCRAUAL BASIS

- Colleges and Universities Summer Sessions 6960.09
- Credit Unions 6120.01
- Deferred Compensation Contract 5230.06

ACCRAUAL BASIS—continued

- Income Tax Expense 1500.03
- Library Book Expenditures 6960.06
- Modified—See Modified Accrual Basis
- Relation to Cash Basis 1500.05

ACQUIRED COMPANY

- Mutual Banks and Associations 6110.03

ACQUIRING COMPANY

- Mutual Banks and Associations 6110.03

ACQUISITION, DEVELOPMENT, OR CONSTRUCTION ARRANGEMENTS

- Accounting Treatment 6110.10
- Characteristics Implying Loan 6110.10
- Expected Residual Profit 6110.10
- Guarantees 6110.10
- Joint Ventures 6110.10
- Loans 6110.10
- Profit Participation 6110.10
- Purchase of 6110.10
- Risks and Rewards 6110.10
- Sale of Expected Residual Profit 6110.10
- Sweat Equity 6110.10

ACTUARIAL COSTS

- Deferred Compensation Contract 5230.07

ACTUARIAL GAINS AND LOSSES

- Changes in Actuarial Assumptions 6960.07
- Unit Credit Method 5230.03

ADMITTANCE FEES

- Retirement Home 5100.21

ADVERSE OPINIONS

- Change in Estimate 9210.03
- Departure from GAAP 2210.09; 2210.18; 9410.13; 9510.08
- Inadequate Property Records 6950.09
- Statutory Reporting Requirements 9510.08
- Unrecorded Tax Liability 9310.01

AFFILIATED COMPANIES

- Abandoned Merger 7620.09
- Accounting Changes 9210.09
- Acquisition of Division 7620.08
- Business Combinations—See Business Combinations
- Combined Financial Statements—See Combined Financial Statements
- Consolidated Financial Statements—See Consolidated Financial Statements
- Control of Board of Directors 1400.07
- Control of Subsidiary Temporarily Lost 1400.15
- Debt Contingently Assumed by Stockholder 3200.08
- Differing Fiscal Years 1400.22; 9430.02
- Divestiture—See Divestiture of Subsidiaries

AFFILIATED COMPANIES—continued

Divisions, Auditor's Responsibility for	9900 05
Division's Financial Statements	7900 01, 9900 05
Earnings per Share	5500 01—02
Equity Method—See Equity Method	
Exchanges of Stock	7600 06
Incorporation of Sole Proprietor	7600 07
Intercompany Transactions	
Between Subsidiary's and Parent's	
Year End	1400 22
Inventory Transfers	1400 08
Purchase Commissions	2210 02
Sale of Receivables	1400 09
Tax Allocation	5250 08—09; 9320 02
Inventory Acquired from Stockholder	8320 03
Inventory Cost Method	1400 23, 2140 11
Joint Ventures	2220 11
Limited Partnership	1400 13, 2220 11
Negative Net Worth	7610 06
Option to Acquire Control	1400 07
Pooling of Interest Method	7600 06
Related Nonprofit Organizations	6400 02
Spin-off of Subsidiaries	7620 10
Subsidiaries, Indirectly Owned	1400 14, 7620 01, 7620 03
Undistributed Earnings of Subsidiary	5250 07

AGREEMENTS—See Contracts**AGRICULTURAL COOPERATIVES**

Equity Method for Investments	7300 05
Patronage Dividend Certificates	4210 03

AIRPLANES

Chartered While Held for Sale	2140 04
Rebuilt Parts Inventory	2140 05

AMORTIZATION

Acquisitions Due to Business	
Combinations	6110 03
Change in Estimated Life	2250 02
Change in Method	5220 05
Commissions on Insurance	6130 04
Computer Software Costs	5240 07
Discounts on Loans	6130 01, 6130 07
Franchises	6910 04
Goodwill	6110 03, 7610 09, 7610 18
Goodwill, Negative	7610 07
Grants Related to Land	2210 22
Intangible Assets	6110 03
Interest Income on Zero Coupon Bonds	5100 31
Inventories	2140 12
Land, Future Transfer of Title	2210 13
Lease Capitalization	7610 16
Leasehold Improvements	5210 09
Loan Costs	4130 03
Log Pond Dredging Cost	2210 15
Mortgage Placement Fee	3200 06
Organization Costs	5240 08
Purchase of Extant Insurance Policy	2240 05

ANNUITIES

Changes in Actuarial Assumptions	6960 07
Deferred Compensation Contract	5230 06
Present Value Calculation	3200 07

APARTMENT HOUSES

Condominium Sales	6600 02
Depreciation of Furnishings	5210 03

APPRAISAL VALUE

Business Combinations	7610 08
Establishing Property Records	6950 09
Fixed Assets	2210 18, 2210 23
Historically Based	6960 02
Intangible Assets	2250 04

APPRAISAL VALUE—continued

Mailing Lists	2210.09
Real Estate Inventory	6610.03
Write-Up in Quasi-Reorganization	2210.18, 4220.01

APPRECIATION

Coins Acquired by Bank	6100.06
Fixed Assets	2210.18

APPROPRIATIONS

Equipment Replacement Funding	2210.16
State Funds for Education	6400.11

ASSESSMENTS

Inquiry Not Sent	9530.09
Inquiry to Client's Attorney	8340.12
Potential Tax Liability	9320.02

ASSETS

Accelerated Cost Recovery System	2210 19, 5210.07
Acquired in a Business	
Combination	6110.03
Acquired With Grant Funds	2210.22
Annuity Asset Adjustments	6960.07
Bank Deposit Float	6100.11
Classification—See Classification of Accounts	
Contributions in Aid to Construction	6950.12
Current—See Current Assets	
Equipment Replacement Funds	2210.16
Fixed—See Fixed Assets	
Intangible—See Intangible Assets	
Land—See Land	
Landfill Rights	6700.10
Law Firm's Recoverable Costs	2130.05
Library Book Expenditures	6960.06
Noncurrent—See Noncurrent Assets	
Offsetting Against Liabilities	1100.11
Patents Developed Internally	5240.04
Purchased at Nominal Prices	7300.14
Purchased in Bulk	7610 09, 7610.19
Reinsurance Contracts	6300.06
Restricted as to Sale	7300.14
Revaluation	2210.18
Sale of Property	1300.09
Tax Basis	2210.19
Transferred in Debt Restructuring	5100.29
Treasury Stock	2260.01
Unclassified Balance Sheet	1100.02
Valuation—See Valuation	
Write-Up in Quasi-reorganization	4220.01

ATTORNEYS—See Lawyers**AUDIT ENGAGEMENT**

Communication Between Predecessor and Successor Accountants	8900.05
Non-Independent Auditor	9520.05
Principal Auditor	9520.05

AUDIT PROGRAMS

Audit Sampling	8220.04
Standardized	8100.01

AUDIT SAMPLING

Applicability of SAS No. 39	8220 01—05
Block Sampling	8220.05
Compliance Tests	8220.01
Definition	8220.01
Design of Sample	8220 01—05
Dual-Purpose Tests	8220.01
Efficiency	8220.02
Errors or Irregularities	8220 02—05
Evidential Matter	8220 01—05
Haphazard Sampling	8220.05
Homogeneous Sampling Groups	8220.02
Illustrations	8220.01
Internal Control	8220.01
Judgment	8220 02—03
Nonstatistical—See Nonstatistical Sampling	

AUDIT SAMPLING—continued

Objectives of Audit	8220.04
Planning	8220.02
Population	8220.03
Random-Number Sampling	8220.05
Representative of Population	8220.02
Risk—See Risk	
Sample Evaluation	8220.01—04
Sample Selection	8220.02—05
Size of Sample	8220.02—03
Statistical—See Statistical Sampling	
Stratified Samples	8220.02
Substantive Tests	8220.01—03
Systematic Sampling	8220.05
Tolerable Error	8220.02—03
Working Papers	8220.04

AUDITING

"Audit" v. "Examination"	9410.10
Brokers/Dealers in Commodities	8340.05
Equity Method for Investments	2220.11
Evidential Matter—See Evidential Matter	
First Audits	9410.04
Internal Control Inadequate	9310.03
Previously Reviewed or Compiled Financial Statements	9600.19
Reliance on State Inspectors	9520.04
Requirements for Regulation A Company	9410.01
Responsibility to Audit Dividend Fund	9520.02
Sampling—See Audit Sampling	
Scope Limitations—See Scope Limitations	
Special Audit of Sales	9510.03
Standards—See Generally Accepted Auditing Standards	
Statistical Sampling—See Statistical Sampling	
Tick Marks on Client Records	8900.01

AUDITORS, INDEPENDENT

Acquisition, Development, or Construction Arrangements	6110.10
Bank Directors' Examination	9510.10
Banks	6100.01, 6100.08—10; 8340.14
Detection of Fraud	8900.04
Disagreement with Management	9410.13
Division's Financial Statements	9900.05
Generally Accepted Government Auditing Standards	6955.06—07; 9110.06
Knowledge of Accounting Practices	9600.18
Predecessor—See Predecessor Auditor	
Principal Auditors	9520.01; 9520.05
Reinsurance Transactions	6300.06
Reliance on Internal Auditors	9520.03
Reliance on State Inspectors	9520.04
Review Report Reissuance	9600.20
Sample Size	8220.03
Sampling	8220.01—05
Successor—See Successor Auditor	
Understanding of Entity	9600.18
Withdrawal from Engagement	9310.03
Work of Other Auditors	9520.05

AUDITORS, INTERNAL

Non-Independent CPA Firm	9520.05
Relation to Independent Auditors	9520.03

AUDITORS' REPORTS

Adverse Opinions—See Adverse Opinions	
"Audit" v. "Examination"	9410.10
Balance Sheet Only	1100.01, 1300.05; 9410.03—04
Balance Sheet Reclassification	1100.13
Basis of Accounting Other Than GAAP	9510.08—09

AUDITORS' REPORTS—continued

Cash Basis Statements	9510.06
Cash Receipts and Disbursements	9510.07
Change from GAAP to Comprehensive Basis of Accounting	9210.10
Comments and Recommendations Reports	9110.04; 9390.03
Compensated Absences	9320.07
Compilation Engagement	9600.08
Compliance Reports—See Compliance Reports	
Compliance with Audit Guides	6900.01
Condensed Financial Statements of a Nonpublic Entity	9410.15
Consistency in Fund Accounting	6950.03
Consolidated and Separate Statements	9410.05
Dates on Cover of Statements	9900.03
Dating of Reports	6100.01
Disclaimers—See Disclaimers of Opinion	
Disclosure—See Disclosure	
Federal Home Loan Mortgage Corp. Preferred Stock	6110.09
Financial Statements Previously Reviewed or Compiled	9600.19
Generally Accepted Government Auditing Standards	9110.06
Going Concern Uncertainties	9320.08; 9390.05; 9410.02
Governmental Audits	9110.06
Inadequate Internal Control	9310.03; 9530.07
Inadequate Property Records	6950.09
Included in Financial Statements	9410.06
Income Tax Basis Statements	9320.08
Inquiry Letter Not Sent	8340.10; 9530.09
Internal Control Reports for Broker-Dealers	6980.01
Inventory Cost Methods	9410.12
Limited Life Ventures	9410.02
Modified Cash Basis Statements	1500.05
Nonprofit Organizations	7300.17
Order of References to Statements	9410.09
Partnership, Limited	7200.05
Period Longer Than Twelve Months	9900.07
Personal Financial Statements	7100.01
Potential Tax Liability	9320.02
Principal Auditors	9520.01
Qualified Opinions—See Qualified Opinions	
Reliance on Others—See Reliance on Other Auditors' Reports	
Representation Letters	8900.03
Reproduction	9410.08; 9900.02
Restatements for Consolidation	9430.02
Scope Limitations—See Scope Limitations	
Single Audit Act of 1984	6955.04
State Prescribed Auditing Standards	9110.04
Statutory Reporting Requirements	9510.08—09
Successor Firm's Signature	9430.01
Supplemental Information	9410.14; 9600.08
Titles of Reports	9900.04
Uncertainties	9320.07
U.S. Government Securities Dealers	9110.07
Violation of Debt Agreement	9410.13

BAD DEBTS—See Uncollectible Accounts

BAILMENTS

Conditional Sales	5100.22
-------------------------	---------

BALANCE SHEET

Allowance for Loan Losses	6100.08
Classification—See Classification of Accounts	
Disclosure of Cash Equivalents	2120.03
Foreign Loan Swaps	6100.12
Inventories at Arbitrary Amount	7300.12
Joint Ventures	2220.03; 2220.05
Landfill Rights	6700.10
Mandatory Redeemable Preferred Stock	4110.08
Minority Interest	1400.24
Notes—See Notes to Financial Statements	
Offsetting Assets and Liabilities	1100.11
Partnerships—Future Capital Contributions	7200.06
Prior Period Adjustment	1300.11
Reclassification	1100.13
Report on Balance Sheet Only	1100.01, 1300.05; 6100.01, 9410.03—.04
Retained Earnings of S Corporation	7910.03
Supplemental Information	9600.08
Supporting Schedules	9600.08
Titles of Financial Statements	1500.04
Treasury Stock as an Asset	2260.01
Unclassified	1100.02—.03; 1100.13; 6610.01

BANK ACCOUNTS—See Cash**BANKRUPTCY**

Commitment under Compromise Agreement	3500.03
Deficit Carried Forward	4220.03
Note from Reorganized Debtor	9330.02

BANKS

Allowance for Loan Losses	6100.04; 6100.08
Confirmation Forms	8340.07; 8340.14
Custodial Reports on Securities	8310.01
Date of Directors' Examination	6100.01
Deferred Taxes	6100.04
Deposit Float	6100.11
Directors' Examination	9510.10
Fixed Assets at Nominal Value	6100.05
Foreign Loans	6100.10; 6100.12
Gain on Sale of Coins	6100.06
Insider Loans	6100.08; 7400.05
Internal Control Reports for Stock Transfer Agents	9110.05
Letters of Payment Guarantees	3500.02
Loan Participations	6100.08
Loans Purchased from Other Banks	6100.08
Loans to Employee Stock Ownership Plans	4140.06
Mortgage Loans Sold with Servicing Rights Retained	6110.05
Mutual Banks and Associations—See Mutual Banks and Associations	
Outstanding Checks	1100.08
"Pay Any Day" Loans	3200.09
Receivables Transferred to Bank	2130.04
Reports of Regulatory Authorities	6100.09
Stock Dividends	6100.07
Troubled Industry Loans	6100.10

BARGAIN SALES

Capital Stock Issuance	4110.04
Free Service Contract	5100.06
One-cent Sales	5100.07

BASE STOCK METHOD

Nonprofit Organization	7300.12
Restaurant Dishes	2210.08

BASIS—See Valuation**BASIS OF ACCOUNTING**

Break-Even Financial Statements	9900.06
Going Concern Assumption	9320.08
Income Tax Basis	9320.08

BENEFIT PLANS—See Employee Benefit Plans**BONDS PAYABLE—See Noncurrent Liabilities****BOOK VALUE**

Sale of Property	1300.09
Shares of Deceased Stockholders	3400.02
Stock Dividends, Closely-Held Companies	4150.03

BREAK-EVEN FINANCIAL STATEMENTS

Accountants Report	9900.06
--------------------	---------

BROKER-DEALERS

Compliance With Capital Adequacy Guideline	9110.07
Government Securities Dealers	9110.07
Internal Control Reports	6980.01, 9110.07

BROKERAGE FIRMS

Confirmations of Commodity Positions	8340.05
Prescribed Forms	9600.09
Unclassified Balance Sheet	1100.02

BULK PURCHASES

Valuation of Assets	7610.09; 7610.19
---------------------	------------------

BURDEN—See Overhead**BUSINESS COMBINATIONS**

Acquisition Costs	6410.03
Bulk Purchase of Assets	7610.09; 7610.19
Contingent Bailout Provisions	7620.15
Contract to Acquire Corporation	7600.03
Date of Acquisition	7600.01—.03
Discount on Exchanged Stock	7630.02
Divestiture—See Divestiture of Subsidiaries	
Division Acquisition	7620.08
Downstream Mergers	7610.01
Exchange of Assets of No Book Value	2220.08
Exchange of Common Stock for Real Estate	2210.21
Exchanges of Stock	7600.06
Future Issuance of Stock	7600.04
Goodwill—See Goodwill	
Income during Acquisition Period	7610.02
Incorporation of Sole Proprietor	7600.07
Indirectly Owned Subsidiaries	7620.01
Initiation, Consummation, and Resolution	7600.04
Leasehold Improvements	7610.15
Leases	7610.16
Legal Costs of Merger	7600.05
Minority Interest Acquisition	7610.18, 7620.06
Mutual Banks and Associations	6110.02—.04
Negative Net Worth	7610.06
Purchase Price Dispute	3400.01, 7610.14
Push-Down Accounting	7610.19
Related Companies	7600.06; 7620.03—.07, 7620.09; 7620.12
Step Up in Basis of Assets	7610.19
Survivor Company	7610.01
Tax Benefit Acquired	5250.06
Tax Effect of Assigned Values	7610.12
Tax Effect of Subsidiary's Undistributed Earnings	5250.07
Temporary Management Agreements	7610.02
Treasury Stock	7620.11, 7620.16
Valuation of Acquisitions	7610.06—.13, 7610.19

BUY-SELL AGREEMENTS

Disclosure	2240.02, 9390.01
------------	------------------

CABLE TV SYSTEMS

Valuation of Subscriptions	2250.04
----------------------------	---------

CAPITAL, CONTRIBUTED—See
Contributed Capital

CAPITAL GAINS AND LOSSES

- Involuntary Conversion 5400.03

CAPITAL LEASES

- Allocation of Payments for Lease
- Capitalized at Fair Value 2210.24; 3200.10
- Bargain Purchase Option 2210.24
- Fixed Assets 2210.24
- Property Leased from Spouse 5600.02

CAPITAL STOCK

- Bargain Sale to Customer 4110.04
- Contingently Convertible Stock 5500.05
- Costs of Issuance 4110.01; 4110.03—04; 7600.05
- Cumulative Preferred Stock 5500.06
- Discounts 4110.02; 4110.04—05; 4230.02; 7630.02
- Disinvestment through Exchange of Stock 4120.04
- Exchange of Common for Preferred 4230.02
- Fair Value 4110.03—04
- Impairment of Capital 2210.18; 4120.03
- Investments, Long-Term—See Investments, Long-Term
- Investments, Temporary—See Investments, Temporary
- Issuance for No Consideration 4110.02
- Issuance for Real Estate 2210.21
- Issued to Officer 4110.05
- Liability to Redeem Stock 4140.03
- Liquidating Dividends Written off 4210.01
- Mandatory Redeemable Preferred Stock 4110.08
- Noncumulative Preferred Stock 5500.07
- Options—See Stock Options and Stock Purchase Plans
- Purchase Plans—See Stock Options and Stock Purchase Plans
- Reinstatement of Redeemed Stock 4120.01
- Restricted—See Restricted Securities
- Stock Dividends—See Stock Dividends and Stock Splits
- Stock Splits—See Stock Dividends and Stock Splits
- Transfer from Retained Earnings 4230.01
- Treasury Stock—See Treasury Stock
- Two Class Common Stock 5500.04—05
- Warrants—See Warrants

CAPITALIZATION

- Accounting Period 2210.20
- Amount to Be Capitalized 2210.20
- Compounding 2210.20
- Computer Software Costs 5240.07
- Facility Constructed by
- Municipality 2210.14
- Holding Costs 6110.06
- Interest Costs 2210.20; 6110.06
- Land Costs 6610.04
- Leases 1500.05
- Library Book Expenditures 6960.06
- Log Pond Dredging Costs 2210.15
- Maintenance Costs 6200.01
- Merger Costs 7600.05
- Power Service Rights 6200.03
- Reacquisition of Sales Contract 6610.02
- Real Estate Costs 6110.06
- Ski Slope Development 2210.07
- Stock Dividends, Banks 6100.07
- Stock Dividends, Closely-Held Companies 4150.01, 4150.03

CARRYFORWARDS AND CARRYBACKS

- Financial Statement Presentation 5250.03
- Investment Tax Credits 5250.12
- Recognition in Income 5250.12

CARRYFORWARDS AND CARRYBACKS—
continued

- Tax Benefit as Extraordinary Item 5250.05; 5250.12—13

CASH

- Balance Sheet Presentation 1100.08; 2120.03
- Bank Confirmations 8340.14
- Brokers/Dealers in Commodities 8340.05
- Cash Count for Bank 6100.01
- Cash Flow Statements 1300.02; 9510.07
- Coins Acquired by Bank 6100.06
- Control of Deposits 2110.01
- Control of Receipts of Vending Machines 8200.02
- Deficits—See Deficits
- Equivalents 2120.03
- Outstanding Checks 1100.08
- Salesmen's Drafts Outstanding 2110.03
- Savings Account of Debtor 2110.04
- Transfers Between Funds 6950.07
- Undelivered Checks 2110.02
- Voided Checks 8210.02

CASH BASIS

- Auditor's Report 9510.06
- Consistency 6950.03
- Deferred Taxes 5250.01—02
- Distinguished from Cash Flow 9510.07
- Financial Statement Captions 1500.04
- Income Tax Expense 1500.03
- Modified—See Modified Cash Basis
- Relation to Accrual Basis 1500.05

CASH ON DELIVERY SALES

- Bankruptcy Compromise Commitment 3500.03

CASH SURRENDER VALUE

- Classification 2240.01
- Deferred Compensation Contract 5230.07
- Excess Purchase Price 2240.05
- Gift to Nonprofit Organization 7300.16
- Policy on Debtor 2240.04
- Reserve for Future Loss 2240.03
- Stock Repurchase Plan 2240.02

CATTLE

- Valuation of Herd 2210.06

CEMETERIES

- Perpetual Care Trust 7500.01

CETA—See Comprehensive Employment and Training Act

CHANGES, ACCOUNTING—See
Accounting Changes

CHARITABLE CONTRIBUTIONS—See
Contributions

CHARITABLE ORGANIZATIONS—See
Not-for-Profit Organizations

CLAIMS

- Employee Benefit Plans 6930.02
- Health Maintenance Organization 6300.07
- Inquiry Not Sent 9530.09
- Inquiry to Client's Attorney 8340.12
- Insurance Companies 8340.09
- Liability for Unasserted Claims 6300.07

CLASSIFICATION OF ACCOUNTS

- Add-on Interest 3200.04
- Cash Surrender Value 2240.01
- Cattle Herd 2210.06
- Charter Airplanes Held for Sale 2140.04
- Current Assets to Pay
- Commitment 2120.01
- Deferred Tax Liability 2130.02; 5250.01—02
- Deposit on Equipment to Be Purchased 2230.02
- Disposal of Segment 1200.03

CLASSIFICATION OF ACCOUNTS—

continued

Expenses Which Are Taxable to Employees	5290.02
Future Capital Contributions	7200.06
Grain Stored for Others in Elevator	1100.12
Housing Held Pending Financing	7300.02
Idle Property	1100.06
Indefinitely Deferred Payables	3200.05
Installment Receivables	2130.02
Landfill Rights	6700.10
Loan Against Insurance	2240.01
Minority Interest	1400.24
Outstanding Checks	1100.08
Property Held for Sale and Leaseback	2210.12
Replacement Parts Inventory	2140.12
Restaurant's Dishes	2210.08
Slow-Moving Inventory	2140.13
Small Business Investment Companies	5100.24
Subordinated Debt	6130.06
Trial Balances	9600.03
Unamortized Debt Discounts	3200.01—04
Unclassified Balance Sheets	1100.02—03, 1100.13; 6610.01
Unearned Revenue	3600.01
Violation of Debt Agreement	9410.13

CLIENT RECORDS

Computer Generated Financial Statements	9600.11
Inadequate	6950.09; 9530.07
Out-of-Pocket Costs	2130.05
Perpetual Inventories	8320.05
Stock Issuance Costs	4110.01
Tick Marks in Client Records	8900.01
Trial Balances—See Trial Balances	

CLIENTS

Correction of Error	5300.01
Disagreement with Auditor	9410.13
Economic Dependency on Supplier	9390.05
Records—See Client Records	
Refusal to Send Inquiry	8340.10; 9530.09
Unasserted Claims and Assessments	8340.12

CLOSELY HELD COMPANIES

Disclosure of Owner-Manager Salary	7400.04
Exchanges of Stock	7600.06
Fair Value of Stock	5500.16
Personal Holding Companies	1600.01
Stock Dividends	4150.01, 4150.03
Stock Issuance Costs	4110.01
Stock Issued to Officer	4110.05
Stockholder Agreements	3400.02; 9390.01

CLOTHING, RENTAL

Depreciation	5210.04
--------------	---------

CLUBS

Excise Tax on Dues	5100.11; 9310.01
Indefinite Term Memberships	5100.09
Life Membership Fees	5100.08
Members' Debt Retirement Assessment	5100.10

COAL

Estimation of Quantity	8320.04
Production Royalties	6500.03

COIN-OPERATED MACHINES

Control of Cash Receipts	8200.02
--------------------------	---------

COLLATERAL

Loan Balances	6100.08
---------------	---------

COLLEGES AND UNIVERSITIES

Annuity Liability and Fund Balance	6960.07
------------------------------------	---------

COLLEGES AND UNIVERSITIES—

continued

Changes in Financial Position	1300.07
Compliance with Audit Guide	6960.01; 9510.09
Employee Compensated Absences	6960.11
Gift of Property	7300.13
Historically Based Appraisal Values	6960.02
Income Trust Corpus as Asset	7500.01
Indirect Costs of Auxiliary Enterprises	6960.04
Library Book Expenditures	6960.06
Mandatory Interest Transfers	6960.03
Overhead Allocation	6960.12
Pledges Receivable	6960.05
State University Medical School	6400.11
Summer Session in Two Fiscal Years	6960.09
Wash Sale of Securities	5100.30

COMBINATION METHOD

Finance Company Income	6130.07
------------------------	---------

COMBINED FINANCIAL STATEMENTS

Accounting Changes	9210.09
Commonly Owned Companies	1400.06; 1400.18
Funds with Homogeneous Operations	6950.11
Hospitals	6400.01—02
Intercompany Profits on Sale of Receivables	1400.09
Limited Partnerships	1400.13

COMMISSIONS

Income Statement Presentation	1200.01
Insurance	6130.04; 6300.01—02
Purchaser's Commissions	2210.02
Real Estate Brokers	6600.01

COMMITMENT LETTERS

Revenue Recognition	5100.14
---------------------	---------

COMMITMENTS

Bankruptcy Compromise Agreements	3500.03
Coal Production Royalties	6500.03
Cotton Futures Contracts	5400.02
Current Assets Appropriation	2120.01
Guarantees of Investee Losses	2220.12
Landfill Rights	6700.10
Letter of Payment Guarantee	3500.02
Letters of Credit	3500.05
Purchase Commitment Losses	3500.04
Purchase Payments Held in Escrow	2210.05
Sale of Unfinished Goods	5100.19
Stockholder Agreements	2240.02; 9390.01
Uncertain Timber Contract	3500.01

COMMODITIES

Audits of Brokers/Dealers	8340.05
Futures Contracts	5400.02

COMMON STOCK—See Capital Stock**COMMON STOCK EQUIVALENTS**

Convertible Debentures of Utility	5500.10
Options Exercisable Within Five Years	5500.12

COMPENSATION

Absences	9320.07
CETA Reimbursements	7300.15
Deferred Compensation Contract	5230.06—07
Disclosure of Owner-Manager Salary	7400.04
Donated Services	7300.07
Medicare Fees of Physicians	6400.04
Stock Issued to Officer	4110.05

COMPENSATION—continued

Stock Options—See Stock Options and	
Stock Purchase Plans	
Teachers' Salaries	3100 05
Use of Company Auto	5290 02

COMPILATION ENGAGEMENTS

Departures from GAAP	9600 01
Supplemental Information	9600 08

COMPILATION OF FINANCIAL STATEMENTS

Basic Statements	9600 08
Break-Even Financial Statements	9900 06
Departures from GAAP	9600 01
Disclosure Requirements	9600 06, 9600 12
Liquidation Basis of Accounting	9600 13
Marking of Pages	9600 04
Subsequent Auditing of Financial Statements	9600 19
Supplemental Information	9410 14, 9600 08
Working Trial Balance	9600 03

COMPILATION REPORTS

Accountant's Responsibility	9600 18
Break-Even Financial Statements	9900 06
Brokers or Dealers in Securities	9600 09
Comprehensive Basis of Accounting	9600 12
Computer Generated Financial Statements	9600 11
Emphasis of a Matter	9600 14—15
Inconsistencies	9600 14—15
Knowledge of Accounting Practices	9600 18
Modification for Prospective Financial Statements	9600 17
Omission of Disclosures	9600 14
Omission of Income Taxes From Interim Financial Statements	9600 21
Prescribed Forms	9600 09—10
Reference to Report in Notes to Financial Statements	9600 16
Responsibility for Prior Period Reviewed Financial Statements	9600 20
Subsequent Issuance of Audit Report	9600 19
Sufficient Relevant Data	9600 18
Supplemental Information	9410 14, 9600 08
Uncertainties	9600 14—15
Understanding of Entity	9600 18

COMPLETED CONTRACT METHOD

Expected Loss	5260 01
Investment on Equity Method	2220 03
Long-Term Contracts	6700 01
Prepaid Funeral Plan	5100 04
Retained Percentages	6700 06
Short-Term Contracts	6700 01

COMPLIANCE REPORTS

Departures from Audit Guides	6960 01
Internal Control Reports for Stock Transfer Agents	9110 05
Internal Control Reports for U S Government Securities Dealers	9110 07
Prescribed Auditing Standards	9110 04
Prescribed Forms—See Prescribed Report Forms	
School Construction Trust	9390 03

COMPLIANCE TESTS

Auditing Sampling	8220 01
-------------------	---------

COMPREHENSIVE BASIS OF ACCOUNTING

Additional First Year Depreciation	5210 08
Change from GAAP	9210 10
Disclosure Requirements	9600 06, 9600 12
Illustrative Report	9210 10
Prescribed Forms	9600 10

COMPREHENSIVE BASIS OF ACCOUNTING—continued

Review of Financial Statements	9600 10
Special Reports	9510 09
Statement of Changes Omitted	1300 10

COMPREHENSIVE EMPLOYMENT AND TRAINING ACT

Accounting for Grants	7300 15
-----------------------	---------

COMPUTER SOFTWARE

Management Information Systems	5240 07
--------------------------------	---------

CONDENSED FINANCIAL STATEMENTS

Filing With a Regulatory Agency	9410 15
Nonpublic Enterprises	9410 15

CONDOMINIUMS

Recognition of Sales	6600 02
----------------------	---------

CONFIRMATIONS

Additional Paid-up Insurance	8340 04
Alternative Procedures	8340 13
Brokers/Dealers in Commodities Factored Receivables	8340 05
Forms for Audited and Unaudited Statements	8340 06, 8340 14
Governments and Large Corporations	8340 02
Inquiries to Client's Attorney	8340 10
Insurance Claims	8340 09
Inventories in Public Warehouse	8320 06
Investments in Securities	8310 01—02
Leased Equipment	8330 02
Loan Balances	6100 08, 8340 03
Modified Cash Basis Statements	8340 11
Negative	8340 13
Pledges Receivable	6920 04
Positive	8340 13
Postage-Paid Return Envelopes	8340 08
Receivables	8340 13
Returned to Internal Auditors	9520 03
Scope Limitations—See Scope Limitations	
Signature on Bank Confirmation	8340 07
Taxes Receivable	6950 05

CONSIDERATION

Issuance of Capital Stock	4110 02
---------------------------	---------

CONSIGNMENTS

Inventories in Public Warehouse	8320 06
---------------------------------	---------

CONSISTENCY

Accounting and Review Services	9600 14—15
Accounting Changes—See Accounting Changes	
Cash Basis Statements of School	6950 03
Change from GAAP to Comprehensive Basis of Accounting	9210 10
Colleges and Universities Summer Sessions	6960 09

CONSOLIDATED FINANCIAL STATEMENTS

Accounting Changes	9210 09
Commonly Controlled Companies	1400 18; 7600 06
Comparison with Equity Method	7600 06
Consolidation Requirements	1400 01, 1400 18
Contingent Assets	1400 21
Control by General Partners	1400 19
Control of Board of Directors	1400 07
Differing Fiscal Years	1400 22, 9430 02
Earnings per Share	5500 01—02
Foreign Subsidiaries	1400 01, 2210 18
Goodwill—See Goodwill	
Guarantee of Debt	1400 21
Incompatible Operations	7300 05
Indirect Subsidiaries	1400 14
Intercompany Profits	1400 09, 2220 08

CONSOLIDATED FINANCIAL STATEMENTS—continued

Intercompany Transactions	
Between Subsidiary's and Parent's	
Year End	1400.22
Inventory Transfers	1400.08
Purchase Commissions	2210.02
Sale of Receivables	1400.09
Tax Allocation	5250.08—09; 9320.02
Inventory Method for Subsidiaries	
	1400.23; 2140.11
Joint Ventures	2220.11
Limited Partnership	1400.13; 1400.19; 2220.11
Minority Interest	1400.02; 1400.21; 1400.24
Option to Acquire Control	1400.07
Principal Auditor	9520.01
Proprietorship and Corporation	1400.02
Related Tax-Exempt Organizations	
	6400.02
Separate and Consolidated Statements	
Auditor's Opinions	9410.05
Disclosure	1400.06
Investment in DISC	1400.05
Temporary Loss of Subsidiary Control	1400.15

CONSTRUCTION CONTRACTORS

Completed Contract Method—See Completed Contract Method	
Cost-plus-fixed-fee Contracts	6700.05
Drawings in Excess of Capital	7200.01
Joint Ventures—See Joint Ventures	
Long-term v. Short-term Contracts	
	6700.01
Payments for Landfill Rights	6700.10
Percentage of Completion—See Percentage of Completion Method	
Retained Percentages	6700.06
Tax Allocation	5250.02
Unclassified Balance Sheet	1100.03

CONTINGENT ASSETS

Disclosure Requirements	1400.21
Guarantee of Debt	1400.21

CONTINGENT CONSIDERATION

Commitment Letters	5100.14
Goodwill	2250.02

CONTINGENT LIABILITIES

Civil and Criminal Tax Penalties	9320.02
Coal Production Royalties	6500.03
Compensated Absences	9320.07
Employees' Stock Ownership Trust Plan	4140.03
Guarantee against Loss	9320.05
Leases Assigned with Recourse	5600.01
Letter of Payment Guarantee	3500.02
Litigation	3100.06; 3400.01
Receivables, Discounted	9210.08
Stockholder Agreements	3400.02

CONTRACTORS—See Construction Contractors**CONTRACTS**

Acquisition of Corporation	7600.03
Agreements to Export Goods	7920.03
Completed Contract Method—See Completed Contract Method	
Cost-plus-fixed-fee	6700.05
Cotton Futures	5400.02
Deferred Compensation	5230.06
Employee Benefit Plans	6930.02
Executory	2210.05; 3500.01
Expected Loss on Contract	5260.01
Franchises—See Franchises	
Free Service Contract	5100.06
Land, Future Transfer of Title	2210.13
Long-term v. Short-term	6700.01

CONTRACTS—continued

Memberships of Indefinite Terms	5100.09
Noncompetition Agreement	5100.23
Obtained for Others	5100.27
Parts Completed Not Shipped	5100.25
"Pay Any Day" Loans	3200.09
Percentage of Completion Method—See Percentage of Completion Method	
Private Label Sales	5100.28
Purchase Commitment Losses	3500.04
Reacquisition of Sales Contract	6610.02
Real Estate—See Real Estate	
Receivables Transferred to Bank	2130.04
Redemption of Stock	4120.03
Reinsurance	6300.06
Retained Percentages	6700.05—06
Revenue Recognition Criteria	5100.25; 5100.27
Short-term	6700.01
Special Audit	9510.01
Stockholder Agreements	2240.02; 3400.02; 9390.01
Timber Purchase Contract	3500.01

CONTRIBUTED CAPITAL

Appropriations	5100.10
Classification of Future Capital Contributions	7200.06
Combined with Deficit	4220.02—03
Commission Paid to Subsidiary	2210.02
Debt Assumed by Stockholders	3200.08; 4160.01
Exchange of Common Stock for Preferred	4230.02
Extinguishment of Debt	4160.02
Future Contributions from Limited Partnerships	7200.06
Limited Partnerships Syndication Costs	7200.07
Liquidating Dividends Written off	4210.01
Members' Debt Retirement Assessment	5100.10
Permanent Tax Benefits	5250.06
Stock Issuance Costs	4110.01; 7200.07
Stock Warrants Reacquired	4130.03
Transfers to Entities Under Common Control	7600.08

CONTRIBUTIONS

Assets Purchased at Nominal Prices	7300.14
City Owned Hospital	6400.10; 6400.12
Contributed Services	7300.07
Custodial Funds	7300.09
Donated Equipment Rented to Patients	5100.22
Gifts in Kind	6920.03
Gifts of Life Insurance Policies	7300.16
Grants-in-Aid	7300.08; 7300.12
In Aid to Construction	6950.12
Life Estate Retained by Donor	7300.13
Pledges	
Confirmation of Receivables	6920.04
Financial Statement Presentation	6960.05
Political	9310.02
Real Estate Investments	6920.09
Securities Held for Life Beneficiaries	7300.06

CONTROL

Consolidation of Limited Partnerships	1400.19
Sampling Risk	8220.05

CONVERTIBLE STOCK

Earnings per Share	5500.05
--------------------	---------

COOPERATIVES

Patronage Dividend Certificates	4210.03
---------------------------------	---------

COST

· Bulk Purchase of Assets	7610.09
· Cattle Herd	2210.06
· Computer Software Costs	5240.07
· Depreciation in Overhead	5210.02
· Expansion of Established Enterprise	5240.06
· Franchisors	6940.01
· Fund Raising Expenses	6920.07
· Historical—See Historical Cost	
· Intercompany Tax Allocation	5250.08—09
· Inventory Methods	1400.23; 2140.11; 9410.12
· Issue—See Issue Cost	
· Land Costs to Parcels Sold	6610.04
· Landfill Rights	6700.10
· Leasehold Improvements	5210.09
· Limited Partnerships Syndication Costs	7200.07
· Log Pond Dredging Costs	2210.15
· Management Costs	6410.03
· Patents Developed Internally	5240.04
· Sales and Production Divisions	5240.01
· Ski Slope Development	2210.07
· Standard Cost Inventory Valuation	2140.09

COST OF LIVING ADJUSTMENTS

· Interest Expense	5220.02
--------------------	---------

COST-PLUS-FIXED-FEE CONTRACTS

· Income Recognition	6700.05
· Private Label Sales	5100.29

COST PRINCIPLE

· Fixed Assets	2210.23
----------------	---------

CREDIT UNIONS

· Interest Revenue Recognition	6120.01
· Marketable Securities	6120.02

CREDITORS

· Economic Dependency of Client	9390.05
· Violation of Debt Agreement	9410.13

CURRENT ASSETS

· Appropriated for Construction Obligations	2120.01
· Cash Equivalents	2120.03
· Classification—See Classification of Accounts	
· Definition	2140.13
· Inventories—See Inventories	
· Investments—See Investments, Temporary	
· Receivables—See Receivables	
· Unclassified Balance Sheet	1100.02—03; 6610.01

CURRENT LIABILITIES

· Accrued Teachers' Salaries	3100.05
· Accumulated Eligibility Credits	6930.01
· Coal Production Royalties	6500.03
· Debt in Violation of Agreement	9410.13
· Deferred Taxes	2130.02; 5250.01—02
· Deposits on Leased Equipment	3100.03
· Estimated Unemployment Claims	3100.01
· Expected Loss on Contract	5260.01
· Gain from Debt Restructuring	5100.29
· Interest Payable Computation	5220.03
· Litigation Refunds	6300.03
· Litigation Settlement	3100.06
· Medicare Fees of Physicians	6400.04
· Unclassified Balance Sheets	1100.02—03; 6610.01
· Undelivered Payments	2110.02
· Unearned Revenue	3600.01

CUSTODIANS

· Inventories in Public Warehouse	8320.06
· Parts Completed Not Shipped	5100.25
· Report on Securities	8310.01

CUSTOMS DUTIES—See Tariffs

AICPA Technical Practice Aids

022—73

CYCLE BILLING

· Unbilled Receivables	6200.02
------------------------	---------

DATE

· Change in Fiscal Year	9210.04
· Cover for Financial Statements	9900.03
· Different Fiscal Years	1400.20; 9430.02
· Notes to Financial Statements	1400.17
· Report on Balance Sheet Only	6100.01
· Representation Letter	9430.03

DEBT—See Loans

DEBT RESTRUCTURING

· Capitalization of Interest	6110.06
· Foreign or Troubled Debt	6100.10
· Gain from Transfer of Assets	5100.29

DEFALCATIONS—See Fraud and Irregularities

DEFERRALS

· Classification of Deferred Taxes	5250.02
· Debt Issuance Costs	3200.01; 3200.06
· Depreciation—See Tax Allocation	
· Expansion of Established Enterprise	5240.06
· Finance Company Income	6130.07
· Franchises	6940.01
· Interest Expense	5220.01
· Investment Tax Credit—See Tax Allocation	
· Landfill Rights	6700.10
· Loan Costs	4130.03
· Maintenance Costs	6200.01
· Medicare Claims	6410.02
· Mortgage Placement Fees	3200.06
· Patents Developed Internally	5240.04
· Research and Development	5240.05
· Sales of Mortgage Loans with Servicing Rights Retained	6110.05
· Taxes—See Tax Allocation	
· Timber Purchase Commitment	3500.01
· Timing Differences—See Timing Differences	
· Uncompleted Contract Income	6700.05

DEFICITS

· Combined with Paid-in Capital	4220.02—.03
· Dividends in Excess of Retained Earnings	7910.01
· Premium—See Premium Deficits	
· Purchase of Treasury Stock	2210.18; 4120.03
· Written off	4220.01—.03

DEPARTMENT OF EDUCATION—See State and Local Governments

DEPARTURES FROM ESTABLISHED PRINCIPLES

· Break-Even Financial Statements	9900.06
· Prescribed Forms	9600.10
· Review of Financial Statements	9600.10

DEPOSITS

· Bank Deposit Float	6100.11
· Equipment to Be Purchased	2230.02
· Held in Escrow	2210.05
· Leased Equipment	3100.03

DEPRECIATION

· Accelerated Cost Recovery System v. Financial Reporting	2210.19; 5210.07
· Additional First Year Depreciation	5210.08
· Appliances in Apartments	5210.03
· Asset Basis	2210.19
· Bank's Fixed Assets	6100.05
· Cattle Herd	2210.06
· Change in Asset Lives	9210.03
· Change in Method	1300.08; 5210.01
· Charter Airplanes	2140.04

DEPRECIATION—continued

• Composite Method	5210.03
• Deferred Taxes	2210.19
• Definition	5210.08
• Demolished Buildings	5210.06
• Depreciation Expense v. Depreciation Accrual	5210.02
• Differing Methods on Prospective and Historical Financial Statements	9600.17
• Disclosure on Balance Sheet	5210.02, 9410.03
• Golf Courses	5210.05
• Housing Held Pending Financing	7300.02
• Included in Inventory Overhead	5210.02
• Log Pond Dredging Costs	2210.15
• Modified Cash Basis Statements	1500.03, 1500.05
• Municipal Utility	6950.12
• Not-for-Profit Organizations	6920.08
• Nursing Homes	6410.02
• Plant Fund Expenses	6920.07
• Real Estate Investment of Defined Benefit Plan	6935.02
• Rental Clothing	5210.04
• Restaurant's Dishes	2210.08
• Ski Slopes	2210.07
• Statement of Changes in Financial Position	1300.08
• Tax-Exempt Shipbuilding Fund	5250.10
• Timing Difference	2210.19
• Voluntary Health and Welfare Organizations	6920.08

DEVELOPMENT COSTS—See Research and Development**DEVELOPMENT STAGE ENTERPRISES**

• Definition	5240.06
• Organization Costs	5240.08
• Research and Development Costs	5240.03

DISASTER RELIEF LOANS

• Discounted Present Value	5220.04
----------------------------------	---------

DISC—See Domestic International Sales Corporations**DISCLAIMERS OF OPINION**

• Defalcations Discovered	9310.03
• Income Statement Only	9410.04
• Scope Limitations	9410.04; 9430.02; 9530.01—02; 9530.06—08
• Supplemental Financial Information	9410.12; 9410.14
• Title of Report	9900.04
• Uncertain Tax Penalties	9320.02
• Uncertain Zoning Change	9320.05
• Unremitted Taxes	9310.01

DISCLOSURE

• Accounting Policies	5100.25; 6935.01
• Arrangements with Reorganized Debtor	9330.02
• Assets Purchased at Nominal Prices	7300.14
• Bond Issuance for City Owned Hospital	6400.12
• Carryforwards and Carrybacks	5250.12
• Cash Equivalents	2120.03
• CETA Grants	7300.15
• Change in Accounting Estimate	9210.08
• Change in Amortization Method	5220.05
• Commitments	3500.01—02
• Comparative Financial Statements	1100.07
• Compensated Absences	9320.07
• Comprehensive Basis of Accounting	9600.06; 9600.12
• Contingent Assets	1400.21
• Control of Board of Directors	1400.07
• Corporate Officer's Importance	9390.02

DISCLOSURE—continued

• Cost-Based Appraisal of Fixed Assets	2210.23
• Departures from GAAP	9600.01; 9600.10
• Deposits Held in Escrow	2210.05
• Depreciation	5210.02; 9410.03
• Dividends per Share	4210.02
• Divorced Co-owners	9320.06
• Donated Services	7300.07
• Drawings in Excess of Capital	7200.01
• Earnings per Share Computation	5500.16
• Economic Dependency of Client	9390.05
• Elements of Working Capital	1300.04
• Employee Defalcation	9330.03
• Equipment Replacement Funding	2210.16
• Examination of Banks by Regulatory Authorities	6100.09
• Exchange of Common Stock for Preferred	4230.02
• Expected Loss on Contract	5260.01
• Federal Grants	6950.01
• Fiscal Year Change	9210.04
• Foreign Loans	6100.10
• Goodwill Write-off	2250.05
• Guarantee Against Losses	9320.05
• Guarantee of Debt	1400.21; 2220.13
• Idle Property	1100.06
• Imputed Interest on Demand Loans	5220.06
• Income Taxes of Proprietor	7100.02
• Insurance Claims of Hospital	6400.09
• Intercompany Tax Allocation	5250.08—09
• Inventory Cost Methods	2140.11; 9410.12
• Inventory Not Observed	9430.02
• Inventory of Nonprofit Organization	7300.12
• Land, Future Transfer of Title	2210.13
• Letters of Credit	3500.05
• Liability for Tax Penalties	9320.02
• Life Estate Retained by Donor	7300.13
• Liquidation Basis of Accounting	9600.13
• Litigation	3400.01; 9320.06
• Litigation Settlement Due Municipality	6950.08
• Loan against Insurance	2240.01
• Loans to Officers and Directors	7400.05
• Loss per Share Computation	5500.14
• Losses of Investees	2220.12
• Maintenance of Benefits Provision	6930.02
• Major Source of Income	9390.02
• Maturities of Loans	6130.05
• Merger of Related Companies	7620.07
• Noncumulative Preferred Stock	5500.07
• Omission of Disclosures	9600.17
• Option to Acquire Control	1400.07
• Partnership, Limited	7200.05
• Patent License Termination	5100.20
• "Pay Any Day" Loans	3200.09
• Pensions	9410.03
• Perpetual Care Trust	7500.01
• Personal Debts of Proprietor	7100.01
• Personal Financial Statements	1600.02
• Political Contributions	9310.02
• Premium Deficits	6930.03
• Purchase Commitment Losses	3500.04
• Purchase Option Cancellation Costs	2210.04
• Real Estate Appraisal Value	6610.03
• Receivables Transferred to Bank	2130.04
• Reclassification of Assets	2210.12
• Reinsurance Transactions	6300.06
• Restricted Stock	4110.05
• Restriction on Sale of Assets	7300.14
• Restrictive Covenants	3500.06
• Retained Earnings of S Corporation	7910.03—04

DISCLOSURE—continued

Retained Earnings Transferred to	
Capital Stock	4230.01
Royalty Agreement	6500.03
S Corporations Reversal of Deferred	
Tax Liabilities	7910.05
Salary of Owner-Manager	7400.04
Sale of Property	1300.09
Standard Cost Inventory Valuation	
	2140.09
Stock Option Plans	4140.02—03
Stock Redemption Contract	4120.03
Stockholder Agreements	2240.02; 3400.02;
	9390.01
Titles of Financial Statements	1500.04
Treasury Stock as an Asset	2260.01
Troubled Industry Loans	6100.10
Trust—Trustee Transactions	9390.03
Uncertainties	9600.14—15
Undistributed Earnings of	
Subsidiary	5250.07
Unremitted Taxes	9310.01, 9330.01
Unusual Items	6100.06

DISCONTINUED OPERATIONS

Decision to Discontinue Reversed	1200.03
----------------------------------	---------

DISCOUNTS

Add-on Interest	3200.04
Capital Stock	4110.02; 4110.04—05; 4230.02
Consumer Loans	6130.01
Free Service Contract	5100.06
Long-term Loans	6130.07
Notes Receivable	7400.06
Prepaid Funeral Plans	5100.04
Present Value—See Present Value	
Small Business Investment Loans	5100.24
Stock Exchanged in Merger	7630.02
Trade-ins	5100.01
Unamortized Debt Discounts	3200.01—04

DIVESTITURE OF SUBSIDIARIES

Abandoned Venture	5400.01
Disinvestment through Exchange of	
Stock	4120.04
Income Statement Presentation	1200.02
Noncompetition Agreement	5100.23
Spin-off Prior to Merger	7620.10

DIVIDENDS

Changes in Actuarial Assumptions	6960.07
Cumulative Preferred Stock	5500.06
Dividends per Share	4210.02
Federal Home Loan Mortgage Corp.	
Preferred Stock	6110.09
Liquidating	4120.02; 4210.01, 7910.01
Noncumulative Preferred Stock	5500.07
Patronage Dividends of	
Cooperative	4210.03
Preferential	4120.01
Responsibility to Audit Dividend	
Fund	9520.02
Restrictive Covenants	3500.06
Stock Dividends—See Stock Dividends	
and Stock Splits	
Undistributed Earnings of	
Subsidiary	5250.07

DIVISIONS—See Affiliated Companies

DOMESTIC INTERNATIONAL SALES CORPORATIONS

Export Sales	7920.03
Investments on Equity Method	7920.01
Tax Allocation	7920.01

DONATED CAPITAL

Commission Paid to Subsidiary	2210.02
-------------------------------	---------

DONATIONS—See Contributions

DRAWING ACCOUNTS

Drawings in Excess of Capital	7200.01
-------------------------------	---------

DUES—See Memberships

DUTIES—See Tariffs

EARNINGS PER SHARE

Callable Convertible Debentures	5500.08
Combined Financial Statements	5500.01
Common Stock Equivalents	5500.10;
	5500.12
Compensatory Plan Not in Force	4140.02
Consolidated Financial Statements	
	5500.01—02
Contingently Convertible Stock	5500.05
Convertible Debentures	5500.09
Cumulative Preferred Stock	5500.06
Debentures Held by Government	5500.10
Dividends per Share	4210.02
Fair Value of Stock	5500.16
If Converted Method	5500.09
Interim Financial Statements	5500.03
Loss per Share	5500.14
Noncumulative Preferred Stock	5500.07
Prospective Financial Statements	1700.01
Stock Dividends	5500.15
Stock Options	4140.02; 5500.12—14; 5500.16
Treasury Stock Method	5500.09
Two Class Common Stock	5500.04—05
Warrants	5500.11
Weighted Average Shares	
Outstanding	5500.03

EARNINGS PROCESS

Realization Criterion	5100.25; 5100.27
-----------------------	------------------

ECONOMIC RECOVERY TAX ACT OF 1981

Accelerated Cost Recovery System	
	5210.07

EDUCATIONAL FOUNDATIONS

Gift of Property	7300.13
------------------	---------

EFFICIENCY

Audit Sampling	8220.02; 8220.05
----------------	------------------

EMPLOYEE BENEFIT PLANS

Experience Ratings Adjustments	6930.03
Liabilities	6930.02
Liability for Accumulated Eligibility	
Credits	6930.01
Maintenance of Benefits Provision	
	6930.02
Premium Deficits—See Premium	
Deficits	
Profit Sharing—See Profit Sharing	
Plans	
Reserves for Claims	6930.02
Underwriting Gains and Deficits	6930.03

EMPLOYEE STOCK OWNERSHIP PLANS

Loan from Employer	4140.06
Treasury Stock as an Asset	2260.01

EMPLOYEES

Compensated Absences	6960.11
Deferred Compensation Contract	
	5230.06—07
Jobs Tax Credit	5250.11
Stock Issued to Officer	4110.05
Taxable Expenses	5290.02

EMPLOYEES STOCK OWNERSHIP TRUSTS

Liability to Redeem Shares	4140.03
----------------------------	---------

EMPLOYERS

Employee Compensated Absences	
	6960.11
Expenses Taxable to Employees	5290.02
Loan to Employees' Stock Ownership	
Plan	4140.06

ENGAGEMENT LETTERS

- Reproduction of Financial Statements 9410.08

ENTERPRISE FUNDS

- Changes in Financial Position 1300.07
- Definition 6950.10

ENTITY, ACCOUNTING

- Change in Reporting Entity 9210.09
- Differing Fiscal Years for Tax and Financial Reporting 1400.20

EQUIPMENT—See Fixed Assets**EQUITY METHOD**

- Change in Circumstances 2220.13
- Comparison with Consolidation 7600.06
- Consolidated and Separate Statements 1400.05; 9410.05
- Extraordinary Items 7920.01
- Guarantee of Debt 2220.13
- Indirect Investments 7620.03
- Intercompany Profits 2220.08; 2220.10
- Investee Using Completed Contract Method 2220.03
- Investment in DISC 7920.01
- Investment in Preferred Stock 7300.05
- Joint Ventures 2220.03; 2220.05; 2220.11
- Method of Reporting 2220.05
- Nonprofit Organizations' Investments 7300.05
- Ownership Less than 20 Percent 2220.01
- Real Estate Ventures 2220.12
- Small Business Investment Companies 2220.07
- Subsidiaries Leasing to Parent 1400.18
- Unconsolidated Subsidiaries 1400.01
- Unrealized Appreciation 2220.06

ERROR CORRECTION

- Accounting and Review Services 9600.15
- Change in Amortization Method 5220.05
- Merger Costs Capitalized 7600.05
- Overhead Application 9210.05
- Premiums on Life Insurance 2240.04
- Prior Period Adjustments 5300.01

ERRORS OR IRREGULARITIES

- Audit Sampling 8220.02—05
- Nonsampling Error 8220.02
- Sampling Error 8220.02
- Tolerable Error 8220.02—03

ESCHEAT LAWS

- Unclaimed Refunds 6300.03

ESCROW AGREEMENTS

- Confirmations 8340.11
- Contingently Held Notes 3200.08
- Purchase Payments Held in Escrow 2210.05
- Separate Financial Statements 7500.01
- Stock Held in Business Combination 7620.13

ESTATES

- Life Estate Retained by Donor 7300.13
- Securities Held for Life Beneficiaries 7300.06
- Valuation of Capital Stock 4230.02

ETHICS, CODE OF PROFESSIONAL

- Governmental Audits 6955.06—07
- Statements of Position (AICPA) 7300.17

EVIDENTIAL MATTER

- Audit Sampling 8220.01—05
- Cash 2110.02
- Confirmations—See Confirmations
- Fair Value of Stock Dividend 6110.09
- Fixed Assets—See Fixed Assets
- Insurance Claims 8340.09
- Inventories—See Inventories
- Joint Ventures 2220.11

EVIDENTIAL MATTER—continued

- Limited Partnerships 2220.11
- Planning and Supervision 8220.04
- Receivables—See Confirmations
- Representations—See Representation Letters
- Sampling—See Statistical Sampling
- Securities—See Securities
- Special Audit of Sales 9510.03
- Unremitted Withholding Taxes 9330.01
- Violation of Debt Agreement 9410.13
- Working Papers 8220.04

EXCESS OF ACQUIRED NET ASSETS**OVER COST—See Negative Goodwill****EXCHANGE**

- Common Stock for Preferred Stock 4230.02
- Realization Criterion 5100.25; 5100.27

EXCISE TAXES

- Club Dues 5100.11; 9310.01

EXECUTORY CONTRACTS—See Contracts**EXPENDITURES**

- Accounting for Expenses Taxable to Employees 5290.02
- CETA Reimbursements 7300.15
- Colleges and Universities Summer Sessions 6960.09
- Contributions to Employee Benefit Plans 9410.03
- Dredging Log Pond 2210.15
- Joint Ventures 2220.03; 2220.05
- Library Books 6960.06
- Overhead Allocation of Colleges 6960.12
- Recoverable Costs 2130.05
- Research and Development 5240.03—04
- Statement of Receipts and Disbursements 9510.07
- Transfers Between Funds 6950.07
- Withdrawn Public Offering 4100.07

EXPLORATION COSTS—See Research and Development**EXPORT SALES**

- Domestic Sales to Exporters 7920.03

EXPROPRIATION

- Property Acquired by Urban Renewal 5400.03

EXTINGUISHMENT OF DEBT—See Noncurrent Liabilities**EXTRACTIVE INDUSTRIES**

- Royalty Commitment 6500.03

EXTRAORDINARY ITEMS

- Abandoned Venture 5400.01
- Bargain Sale of Stock 4110.04
- Definition 5400.04
- Extinguishment of Debt 4160.02
- Federal Home Loan Mortgage Corp. Preferred Stock 6110.09
- Gain from Debt Restructuring 5100.29
- Gain on Involuntary Conversion 5400.03
- Gain on Sale of Coins 6100.06
- Goodwill Write-off 2250.05
- Investment on Equity Method 7920.01
- Life Insurance Proceeds of Officer 5400.04
- Sale of Cotton Futures 5400.02
- Statement of Changes in Financial Position 1300.08
- Tax Allocation 5250.03; 5400.03
- Tax Benefit of Loss Carryforward 5250.05; 5250.12—13

FAIR VALUE

- Allocation of Capital Lease Payments 2210.24; 3200.10

FAIR VALUE—continued

Assets Purchased at Nominal Prices	7300.14
Bulk Purchase of Assets	7610.09; 7610.19
Business Combination Acquisitions	6110.03; 7610.19
Charitable Contributions	7300.06
Closely Held Corporation's Stock	5500.16
Debt Restructuring	5100.29
Federal Home Loan Mortgage Corp. Preferred Stock	6110.09
Foreign Loan Swaps	6100.12
Gift of Property	7300.13
Gifts in Kind	6920.03
Intercompany Investments	7300.05
Investment Company Securities	6910.01
Land Costs, Allocation	6610.04
Mutual Banks and Associations	6110.03
Nonreciprocal Transfers	2210.11; 2210.21
Plan Investments in Real Estate	6935.02
Profit Sharing Plan Assets	6935.01
Push-Down Accounting	7610.19
Real Estate Investments	6920.09
Revaluation of Assets	2210.12
Stock Dividends	4150.02; 6100.07
Stock Dividends, Closely-Held Companies	4150.03
Stock Issuance	4110.03—04
Transfers to Entities Under Common Control	7600.08
Unregistered Stock	2220.09

FEDERAL POWER COMMISSION

Chart of Accounts	6200.02
-------------------------	---------

FEES

Accounting	4110.01; 4110.03
Engineering Services	5100.27
Foreign Loan Swaps	6100.12
Franchises—See Franchises	
Lease Assignment	5600.01
Legal—See Legal Fees	
Patents Developed Internally	5240.04
Small Business Investment Companies	5100.24
Underwriting	4110.03

FINANCE COMPANIES

Commissions on Loan Insurance	6130.04
Confirmation of Factored Receivables	8340.01
Disclosure of Maturities of Loans	6130.05
Discount Amortization	6130.01; 6130.07
Revenue Recognition	6130.03; 6130.07
Subordinated Debt Classification	6130.06

**FINANCIAL POSITION STATEMENTS—
See Balance Sheet**

FINANCIAL STATEMENTS

Accounting Policies Disclosure	6935.01
Balance Sheet—See Balance Sheet	
Balance Sheet Only	1100.01; 1300.05
Banks	6100.08—10
Basic Statements	9600.08
Break-Even	9900.06
Cash Basis—See Cash Basis	
Cash Receipts and Disbursements	9510.07
Change from GAAP to Comprehensive Basis of Accounting	9210.10
Change in Estimated Uncollectibles	9210.08
Changes in Financial Position—See Statement of Changes in Financial Position	
Combined—See Combined Financial Statements	
Commonly Owned Companies	1400.18
Comparative Statements	1100.01; 1100.07; 1300.03—04; 9210.10; 9600.20; 9900.03
Compensated Absences	9320.07

FINANCIAL STATEMENTS—continued

Compilation—See Compilation of Financial Statements	
Comprehensive Basis of Accounting	1300.10; 9210.10; 9320.08; 9600.12
Computer Generated	9600.11
Condensed—See Condensed Financial Statements	
Confirmation Request Forms	8340.06
Consolidated—See Consolidated Financial Statements	
Correction of Error	5300.01
Dates on Cover	9900.03
Departure from GAAP	5210.08; 9310.03; 9600.01
Depreciation—See Depreciation	
Development Stage Enterprises	5240.03; 5240.06
Disclosure of Cash Equivalents	2120.03
Disclosure of Receivables Transferred	2130.04
Disposal of Segment	1200.03
Division's	7900.01; 9900.05
Elements of Working Capital	1300.04
Exchange of Common Stock for Preferred	4230.02
Exchange of Common Stock for Real Estate	2210.21
Funds Covering Homogeneous Operations	6950.11
GAAP, In Accordance with	6100.10
Income Statement—See Income Statement	
Income Taxes—See Taxes	
Indian Tribe	6950.01
Interim—See Interim Financial Statements	
Interim Prepared on Different Basis Than Annual Statements	9600.12
Inventory Cost Methods	9410.12
Issuance of Audit Report on Previously Reviewed or Compiled Statements	9600.19
Letters of Credit	3500.05
Liquidation Basis of Accounting	9600.13
Modified Cash Basis—See Modified Cash Basis	
Notes—See Notes to Financial Statements	
Offsetting Assets and Liabilities	1100.11
Order of Presentation	9410.09
Out-of-Pocket Costs	2130.05
Partnerships, Limited	7200.05
"Pay Any Day" Loans	3200.09
Period Covered	9900.07
Personal—See Personal Financial Statements	
Premium Deficits	6930.03
Prescribed Forms—See Prescribed Report Forms	
Prior Period Adjustments	5300.01
Prior Year Unaudited	9900.03
Profit Sharing Plans	6935.01
Proprietorships	7100.01; 7100.02
Prospective Financial Statements—See Prospective Financial Statements	
Reclassification	1100.13
Reference to Auditor's Report	9410.06
Reference to Notes to Financial Statements	9600.16
Relation to Trial Balances	9600.03
Reproduction	9410.08; 9900.02
Restatements	6410.04; 9210.01—02; 9430.02
Review—See Review of Financial Statements	
Sale of Property	1300.09
Single Period Statements	1300.11

FINANCIAL STATEMENTS—continued

• State Department of Education	9510.09
• Statement of Changes Omitted	1300.05.
	1300.10
Statutory Reporting Requirements	
	9510.08—09
• Supplemental Information	9410.14, 9600.08
• Titles of Statements	1500.04
• Trust Funds	7500.01
• Unaudited—See Unaudited Financial Statements	
Unbound Statements	9900.02

FINANCING

• Charges	6130.03
• Hospital Equipment Replacement	2210.16
• Leases Sold or Assigned	5600.01
• "Pay Any Day" Loans	3200.09
• Receivables Transferred to Bank	2130.04
• Special Assessment Bonds	2210.14

FIRM NAME

• Successor Firm's Signature	9430.01
------------------------------	---------

FIRST-IN, FIRST-OUT

• Inventory Method	1400.23, 9410.12
--------------------	------------------

FISCAL YEARS

• Colleges and Universities Summer Sessions	6960.09
• Consolidation with Differing Year-Ends	1400.22
• Consolidation with Differing Years	9430.02
• Differing for Tax and Financial Reporting	1400.20
• Disclosure of Change	9210.04
• Longer Than Twelve Months	9900.07

FIXED ASSETS

• Apartment Appliances	5210.03
• Bank Assets at Nominal Value	6100.05
• Bulk Purchase of Assets	7610.09
• Cattle Herd	2210.06
• Charter Airplanes	2140.04
• Commission Received by Purchaser	2210.02
• Conditional Sales	5100.22
• Demolition of Buildings	2210.03, 5210.06
• Deposit on Equipment to Be Purchased	2230.02
• Depreciation—See Depreciation	
• Donated to Educational Foundation	7300.13
• Equipment Leasing Company	5220.05
• Facility Constructed by Municipality	2210.14
• Golf Course	5210.05
• Historically Based Appraisal Values	6960.02
• Hospital Equipment Replacement	2210.16
• Housing Held Pending Financing	7300.02
• Idle Property	1100.06
• Inadequate Records	6950.09
• Involuntary Conversion	5400.03
• Land, Future Transfer of Title	2210.13
• Library Book Expenditures	6960.06
• Log Pond Dredging Costs	2210.15
• Mailing Lists	2210.09
• Mortgage Payment by Seller	2210.01
• Nonreciprocal Transfers	2210.11, 2210.21
• Not-for-Profit Organizations	6920.07—08; 7300.13
• Partially Acquired With Grant Funds	2210.22
• "Pay Any Day" Loans	3200.09
• Purchase Option Cancellation Costs	2210.04
• Purchase Payments Held in Escrow	2210.05
• Purchased at Nominal Prices	7300.14
• Real Estate Title Verification	8330.01
• Recording Under Capital Lease	2210.24

FIXED ASSETS—continued

• Rental Assets Verification	8330.02
• Rental Clothing	5210.04
• Restaurant Dishes	2210.08
• Sale of Property	1300.09
• Ski Slopes	2210.07
• Trade-ins	5100.01
• Valuation by Cost-Based Appraisal	2210.23
• Valuation in Business Combinations	7610.08—13
• Voluntary Health and Welfare Organizations	6920.08
• Water Authority's Facilities	6950.02
• Write-Ups	2210.18

FOOTNOTES—See Notes to Financial Statements**FOREIGN LOANS**

• Accounting for Swaps	6100.12
• Disclosure	6100.10
• Fair Value of Swaps	6100.12
• Fees and Transaction Costs	6100.12
• Gains From Swaps	6950.12
• Losses From Swaps	6100.12

FOREIGN OPERATIONS

• Consolidation of Foreign Subsidiaries	1400.01, 2210.18
• Foreign Loans	6100.10

FORMS

• Confirmation Requests	8340.06
• Insurance Confirmations	8340.04
• Preprinted Audit Programs	8100.01
• Prescribed Reports—See Prescribed Report Forms	
• Signature on Bank Confirmation	8340.07
• Title for Disclaimer of Opinion	9900.04

FRANCHISE TAXES

• Partnership Tax Allocation	7200.03
------------------------------	---------

FRANCHISES

• Cable TV Systems	2250.04
• Sales of Area Franchises	6940.01
• Substantial Performance	6940.01

FRAUD AND IRREGULARITIES

• Indicators	8900.04
• Management	8900.04
• Scope of Examination	9310.03
• Subsequently Discovered Defalcation	9330.03
• Trust—Trustee Transactions	9390.03
• Unremitted Taxes	9310.01

FUEL OIL DEALERS

• Free Service Contracts	5100.06
--------------------------	---------

FUND ACCOUNTING

• Board-designated Unrestricted Funds	6400.03
• Combined Statements	6400.01—02, 6950.11
• Consistency	6950.03
• Custodial Funds	7300.09
• Employee Benefit Plans—See Employee Benefit Plans	
• Employee Compensated Absences	6960.11
• Endowment Funds	6400.03
• Fund Raising Expenses	6920.07
• Grants-in-Aid	7300.08
• Hospital Equipment Replacement	2210.16
• Indian Tribe	6950.01
• Library Book Expenditures	6960.06
• Modified Accrual Basis for Revenue	6950.08
• Municipal Utility	6950.12
• Overhead Allocation of Colleges	6960.12
• Responsibility to Audit Dividend Fund	9520.02
• School Cafeteria System	6950.10

FUND ACCOUNTING—continued

State Funds for Education . . .	6400 11
Transfers Between Funds . . .	6950 07
Trust Funds . . .	7500 01

FUND RAISING EXPENSES

Voluntary Health and Welfare Organizations . . .	6920 07
--	---------

FUNERAL DIRECTORS

Prepaid Funeral Plans . . .	5100 04
-----------------------------	---------

GAINS

Actuarial—See Actuarial Gains and Losses	
Capital Gains—See Capital Gains and Losses	
Cotton Futures Contracts . . .	5400 02
Debt Restructuring . . .	5100 29
Disposal of Segment . . .	1200 03
Equity Method for Unrealized Gains . . .	2220 06
Exchange of Real Estate . . .	6600 07
Foreign Loan Swaps . . .	6100 12
Involuntary Conversion . . .	5400 03
Sale of Coins . . .	6100 06
Sale of Property . . .	1300 09
Sales of Mortgage Loans . . .	6110 05
Transfers of Receivables . . .	2130 04
Unrealized Gains on Investments . . .	2120 02
Wash Sales . . .	5100 30

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Bases of Accounting . . .	1500 03
Basic Financial Statements . . .	1300 10
Break-Even Financial Statements . . .	9900 06
Bulk Purchase of Assets . . .	7610 09
Cash Receipts and Disbursements . . .	9510 07
Change to Comprehensive Basis of Accounting . . .	9210 10
Changes—See Accounting Changes	
Comprehensive Basis of Accounting . . .	1300 10; 9510 09; 9600 06
Construction Contracts . . .	6700 01
Departures . . .	1500 05; 2210 09; 2210 18; 3300 02; 5210 08; 9310 03; 9410 13; 9510 06; 9510 08—09; 9600 01; 9600 10; 9600 21; 9900 06
Depreciation . . .	5210 08
Development Stage Enterprises . . .	5240 03; 5240 06
Discounts on Long-Term Loans . . .	6130 07
Fixed Asset Records Inadequate . . .	6950 09
Foreign Loan Swaps . . .	6100 12
Funds Covering Homogeneous Operations . . .	6950 11
Hedge Fund . . .	2220 06
Imputed Interest on Demand Loans . . .	5220 06
Inquiries of Predecessor Auditor . . .	8900 05
Liquidation Basis of Accounting . . .	9600 13
Modified Cash Basis Statements . . .	1500 05; 8340 11
Overhead Allocation of Colleges . . .	6960 12
Relation to Accelerated Cost Recovery System . . .	5210 07
Statutory Reporting Requirements . . .	9510 08—09

GENERALLY ACCEPTED AUDITING STANDARDS

Bank Directors' Examination . . .	9510 10
Cash Receipts and Disbursements . . .	9510 07
Confirmation Procedures . . .	8340 08; 8340 11
Governmental Audits . . .	6955 06—07; 9110 06
Inquiries of Predecessor Auditor . . .	8900 02; 8900 05
Inquiries to Client's Attorney . . .	8340 10
Reliance on State Inspectors . . .	9520 04

GENERALLY ACCEPTED AUDITING STANDARDS—continued

Representation Letters . . .	8900 03
Single Audit Act of 1984 . . .	6955 07
State Prescribed Standards . . .	9110 04

GIFTS—See Contributions

GOING CONCERN

Accounting and Review Services . . .	9600 14—15
Economic Dependency on Supplier . . .	9390 05
Financial Statements Prepared on Income Tax Basis . . .	9320 08
Limited Life Ventures . . .	9410 02

GOLD

Inventory Valuation . . .	2140 08
---------------------------	---------

GOLF COURSES

Depreciation . . .	5210 05
--------------------	---------

GOOD FAITH

Investment in Real Estate . . .	6910 03
---------------------------------	---------

GOODWILL

Acquisition of Minority Interest . . .	7610 18
Bulk Purchase of Assets . . .	7610 09
Business Combinations . . .	6110 03
Change in Estimated Life . . .	2250 02; 2250 05
Contingent Consideration . . .	2250 02
Disputed Acquisition Price . . .	7610 14
Issuance of Capital Stock . . .	4110 02
Negative—See Negative Goodwill	
Subsidiary with Negative Worth . . .	7610 06

GOVERNMENTAL ACCOUNTING—See State and Local Governments

GRAIN

Inventory Classification . . .	1100 12
Inventory Measurement . . .	9520 04

GRANTS-IN-AID

CETA Grants . . .	7300 15
Fixed Assets Acquired With Grants . . .	2210 22; 6950 12
Income Statement Presentation . . .	7300 08
Products Sold at a Loss . . .	7300 12

GUARANTEES

Acquisition, Development, or Construction Arrangements . . .	6110 10
Debt of Investees . . .	1400 21; 2220 13
Disclosure Requirements . . .	1400 21
Guarantee against Losses . . .	9320 05
Losses of Investees . . .	2220 12
Minority Interest Guarantee of Debt . . .	1400 21

HEALTH AND WELFARE BENEFIT PLANS—See Employee Benefit Plans

HEALTH MAINTENANCE ORGANIZATION (HMO)

Recognition of Health Care Costs . . .	6300 07
--	---------

HEDGE FUNDS

Equity Method for Unrealized Gains . . .	2220 06
--	---------

HISTORICAL COST

Basis for Asset Valuation . . .	2210 18; 2210 23; 7600 06—07
Exchanges of Stock . . .	7600 06
Fixed Assets . . .	2210 23
Incorporation of Sole Proprietor . . .	7600 07
Transfers to Entities Under Common Control . . .	7600 08

HOLDING COMPANIES

Business Combinations . . .	7620 03; 7620 05
Intercompany Tax Allocation . . .	5250 08—09
Personal—See Personal Holding Companies	

HOMEOWNERS ASSOCIATION

Transfer of Assets . . .	2210 11
--------------------------	---------

HOSPITALS

- Board-designated Unrestricted Funds 6400.03
- Changes in Financial Position 1300.07
- City Owned 6400.10; 6400.12
- Combined Financial Statements 6400.01—.02
- Confirmation of Taxes Receivable 6950.05
- Depreciation of Demolished Building 5210.06
- Equipment Replacement Funding 2210.16
- Issuance of General Obligation Bonds 6400.12
- Medicare Claims Receivable 6400.07—.09
- Medicare Current Financing Payments 6400.06
- Medicare Fees of Physicians 6400.04
- State Funds for Education 6400.11

IDLE PROPERTY

- Balance Sheet Presentation 1100.06

IF CONVERTED METHOD

- Fully Diluted Earnings per Share 5500.09

IMPAIRMENT

- Legal Capital 2210.18; 4120.03

IMPORT DUTIES—See Tariffs**IMPUTED INTEREST**

- Notes Receivable 2130.06
- Shareholder Loans 5220.06

INCOME STATEMENT

- Commissions Income Presentation 1200.01
- Cumulative Effects of Accounting Change 9210.01
- Disclaimer of Opinion 9410.04
- Disposal of Segment 1200.03
- Disposal of Subsidiary 1200.02
- Equipment Replacement Provision 2210.16
- Gain on Involuntary Conversion 5400.03
- Goodwill Write-Off 2250.05
- Joint Ventures 2220.03; 2220.05
- Life Insurance Proceeds of Officer 5400.04
- Liquidation Basis of Accounting 9600.13
- Loss on Foreign Loan Swaps 6100.12
- Notes—See Notes to Financial Statements
- Partners' Income Taxes 7200.02
- Purchase Commitment Losses 3500.04
- S Corporations 7910.04—.05
- Supplemental Information 9600.08
- Supporting Schedules 9600.08
- Title 1200.04

INCOME TAXES—See Taxes**INDEPENDENCE**

- Bank Directors' Examination 9510.10
- Internal Audit Staff 9520.03
- Review Report Reissuance 9600.20
- Work of Other Auditors 9520.05

INDIAN TRIBES

- Financial Statements 6950.01

INDUSTRIAL REVENUE BONDS—See Noncurrent Liabilities**INFLATION**

- Consolidation of Foreign Subsidiaries 2210.18
- Linked to Mortgage Payments 5220.02

INQUIRIES

- Insurance Companies 8340.09
- Legal Counsel 8340.10; 8340.12; 9530.09
- Predecessor Auditor 8900.02; 8900.05
- Review Engagements 9600.02

INSTALLMENT METHOD

- Classification of Discounts 3200.02

INSTALLMENT METHOD—continued

- Classification of Receivables 2130.02
- Disclosure Installment Amounts 6130.05
- Litigation Settlement Due Municipality 6950.08
- Present Value of Annuity Calculation 3200.07
- Receivables Transferred to Bank 2130.04

INSURANCE

- Commissions on Loan Insurance 6130.04
- Confirmation of Policies 8340.04
- Credit Life 6300.02
- Deferred Compensation Contract 5230.07
- Employee Benefit Plans 6930.02—.03
- Estimated Unemployment Claims 3100.01
- Gifts of Life Insurance Policies 7300.16
- Indenture Compliance Audit 9390.03
- Key Personnel 5230.07
- Liability for Accumulated Eligibility Credits 6930.01
- Loan Against Insurance 2240.01
- Policy on Debtor 2240.04
- Proceeds From Officer's Death 5400.04
- Purchase of Extant Policy 2240.05
- Reimbursements to Hospitals 6400.06—.09
- Reinsurance—See Reinsurance
- Revenue Recognition by Brokers and Agents 6300.01
- Surrender Value—See Cash Surrender Value

INSURANCE COMPANIES

- Commission Income 6130.04
- Employee Benefit Plans 6930.03
- Inquiry on Insurance Claims 8340.09
- Reserve for Future Claims 6300.04
- Unclaimed Refunds 6300.03

INTANGIBLE ASSETS

- Appraisal Value 2250.04
- Bulk Purchase of Assets 7610.09
- Business Combinations 6110.03
- Cable TV Subscriptions 2250.04
- Change in Amortization Life 2250.02; 2250.05
- Costs of Maintaining 4110.04
- Goodwill—See Goodwill
- Landfill Rights 6700.10
- Leasehold Improvements 7610.15
- Mortgage Placement Fee 3200.06
- Patents—See Patents

INTERCOMPANY TRANSACTIONS—See Affiliated Companies**INTEREST EXPENSE**

- Add-on Interest 3200.04
- Capitalization—See Capitalization
- Contract to Repurchase Stock 4120.03
- Cost of Living Adjustments 5220.02
- Deferred Interest 5220.01
- Demand Loans to Shareholders 5220.06
- Disaster Relief Loans 5220.04
- Government Established Rates 5220.04
- Imputed Interest 5220.06
- Imputed Interest Rates 5220.04
- Mandatory Interest Transfers 6960.03
- Mortgage Payment by Seller 2210.01
- "Pay Any Day" Loans 3200.09
- Rate Changes 5220.03
- Receivables Transferred to Bank 2130.04

INTEREST METHOD

- Allocation of Capital Lease Payments 3200.10
- Amortization of Prepaid Interest 5220.05
- Zero Coupon Bonds 5100.31

INTEREST REVENUE

- Changes in Actuarial Assumptions 6960.07
- Confirmation of Receivables 8340.03

INTEREST REVENUE—continued

Consumer Loan Discounts	6130.01
Credit Unions	6120.01
Discounts on Long-term Loans	6130.07
Doubtful Accounts	2130.01
Imputed Interest on Notes Receivable	2130.06
Present Value of Annuity Calculation	3200.07
Small Business Loan Discounts	5100.24
Zero Coupon Bonds	5100.31

INTERIM FINANCIAL STATEMENTS

Cash Basis Statements	9600.12
Earnings per Share	5500.03
Income Taxes Omitted	9600.21
Prepared on Different Basis Than Annual Statements	9600.12
Restatement for Consolidation	9430.02

INTERNAL AUDITORS—See Auditors, Internal

INTERNAL CONTROL

Audit Sampling	8220.01
Cash Control of Vending Machines	8200.02
Cash Deposits	2110.01
Fraud and Irregularities	8900.04
Inadequate	9310.03; 9530.07
Inventories in Public Warehouse	8320.06
Material Weaknesses	9110.05
Reliability	8220.01
Reliance on Internal Auditors	9520.03
Single Audit Act of 1984	6955.03; 6955.07
U.S. Government Securities Dealers	9110.07

INTERNAL CONTROL REPORTS

Broker-Dealers	6980.01; 9110.07
Single Audit Act of 1984	6955.04
Stock Transfer Agents	9110.05

INVENTORIES

Average Cost Method for Subsidiary	2140.11
Base Stock Method	2210.08; 7300.12
Beginning Inventory Not Observed	9410.04; 9430.02
Break-Even Financial Statements	9900.06
Broker-Dealers	9110.07
Bulk Purchase of Assets	7610.09
Cattle	2210.06
Charter Airplanes	2140.04
Classification of Slow-Moving Inventory	2140.13
Coal Pile Quantity	8320.04
Depreciation Included in Overhead	5210.02
Different Pricing Methods for Parent and Subsidiary	1400.23
FIFO—See First-in, First-out	
Gold	2140.08
Grain	1100.12; 9520.04
Housing Held Pending Financing	7300.02
Intercompany Transfers	1400.08
LIFO—See Last-in, First-out	
Materiality	9530.01
Meat Packer	2140.06
Net Realizable Value	7300.12
Nonprofit Organizations	7300.12
Observation Before Year-End	8320.01; 8320.05
Obsolescence	2140.02—03; 2140.12; 8320.02
Overhead—See Overhead	
Parts Inventories	2140.05; 8320.02
Perpetual Records	8320.01; 8320.05
Purchase Commitment Losses	3500.04
Purchase from Stockholder	8320.03
Recoverable Tariff Costs	2130.03
Reliance on State Inspectors	9520.04
Replacement Parts	2140.12

INVENTORIES—continued

Restaurant Dishes	2210.08
Scope Limitations	9410.04; 9530.06
Silver	8320.06
Standard Cost	2140.09
Statements Using Differing Methods	9510.01
Stored in Public Warehouse	8320.06
Trade-ins	5100.01
Transfer Prices	5240.01
Valuation in Business Combinations	7610.08—10
Warehousing Costs	2140.01
Work in Process—See Work in Process	

INVESTMENT COMPANIES

Responsibility to Audit Dividend Fund	9520.02
Small Business Investment Companies	2220.07; 5100.24
Valuation of Real Estate	6910.03
Valuation of Securities	2120.04; 6910.01

INVESTMENT TAX CREDIT—See Taxes

INVESTMENTS, LONG-TERM

Consolidated Statements—See Consolidated Financial Statements	
Control of Investee	2220.01
Divestiture with Noncompetition Agreement	5100.23
Domestic International Sales Companies	7920.01
Equity Method—See Equity Method	
Hedge Fund	2220.06
Indirect Subsidiaries	1400.14
Intercompany Profits	2220.08; 2220.10
Joint Ventures	2220.11
Limited Partnership	1400.13; 2220.11
Losses in Excess of Investment	2220.12
Minority Interest—See Minority Interest	
Municipality's Water Authority	6950.02
Nonprofit Organizations	7300.05
Personal Holding Companies	1600.01
Preferred Stock	7300.05
Sale of Subsidiary	4120.04
Small Business Investment Companies	2220.07
Supplemental Unconsolidated Statements	1400.05
Unregistered Stock	2220.09

INVESTMENTS, TEMPORARY

Anticipated Expenditure on Commitments	2120.01
Audit Evidence—See Securities	
Disclosure of Components	2120.03
Insurance on Debtor	2240.04
Joint Ventures—See Joint Ventures	
Nonprofit Organizations	7300.05
Preferred Stock	7300.05
Property Held for Leaseback	2210.12
Real Estate Valuation	6910.03
Securities Held for Life Beneficiaries	7300.06
Unrealized Gains and Losses	2120.02
Unregistered Stock	2220.09
Valuation of Securities	2120.04; 6910.01

IRREGULARITIES—See Fraud and Irregularities

ISSUE COST

Withdrawn Public Offering	4100.07
-------------------------------------	---------

JOBS TAX CREDIT

Accounting Method	5250.11
-----------------------------	---------

JOINT VENTURES

Acquisition, Development, or Construction Arrangements	6110.10
Combined Financial Statements	2220.11

JOINT VENTURES—continued

- Equity Method 2220.03, 2220.05, 2220.11
- Limited Life Venture 9410.02
- Real Estate 2220.12
- Unclassified Balance Sheet 1100.03

JUDGMENT

- Sample Size 8220.03
- Sampling Risk 8220.02
- Troubled Debt Disclosures 6100.10

LAND

- Demolition Costs 2210.03
- Development Companies—See Retail Land Sales
- Future Transfer of Title 2210.13
- Golf Course Depreciation 5210.05
- Purchase Option Cancellation Costs 2210.04
- Ski Slopes 2210.07

LANDFILL RIGHTS

- Classification in Balance Sheets 6700.10

LAST-IN, FIRST-OUT

- Inventory Method 1400.23, 2140.11, 9410.12

LAUNDROMATS

- Control of Cash Receipts 8200.02

LAWYERS

- Advice on Auditors' Withdrawal 9310.03
- Audit Inquiry Not Sent 8340.10; 9530.09
- Inquiry on Insurance Claims 8340.09
- Inquiry on Unasserted Claims 8340.12
- Issuance of Capital Stock 4110.02
- Legal Fees—See Legal Fees
- Out-of-Pocket Costs 2130.05

LEASEHOLD IMPROVEMENTS

- Accounting for 5210.09
- Acquisition in Business Combination 7610.15
- Definition 5210.09

LEASES

- Acquisition in Business Combination 7610.16
- Asset Ownership Verification 8330.02
- Capital—See Capital Leases
- Commonly Owned Companies 1400.18
- Conditional Sales 5100.22
- Deposits on Equipment 3100.03
- Lease Sale or Assignment 5600.01
- Operating—See Operating Leases
- Operating Method 5100.16
- Percentage of Sales Leases 5100.16, 9510.03
- Related Parties 5600.02
- Sale and Leaseback 2210.12

LEGAL FEES

- Business Combinations 7600.05
- Employee Defalcation 9330.03
- Organization Costs 5240.08
- Patents Developed Internally 5240.04
- Stock Issuance Costs 4110.01, 4110.03

LEGAL REQUIREMENTS

- Economic Recovery Tax Act of 1981 5210.07
- Exchange of Common Stock for Preferred 4230.02
- Impairment of Legal Capital 2210.18; 4120.03
- Stock Dividends, Closely-Held Companies 4150.01; 4150.03
- Stock Issued to Officer 4110.05

LETTERS, ENGAGEMENT—See Engagement Letters**LETTERS OF CREDIT**

- Disclosure Requirement 3500.05
- Payment Guarantees 1400.21; 3500.02

LETTERS, REPRESENTATION—See Representation Letters**LIABILITIES**

- Annuity Liability Adjustments 6960.07
- Bank Deposit Float 6100.11
- Contingent—See Contingent Liabilities
- Current—See Current Liabilities
- Debt Restructuring—See Debt Restructuring
- Deferred Compensation Contract 5230.06—07
- Deferred Taxes 2130.02; 5250.01—02; 7910.05
- Employee Benefit Plans 6930.02—03
- Employee Compensated Absences 6960.11
- Excise Taxes 9310.01
- Indefinitely Deferred Payables 3200.05
- Life Estate Retained by Donor 7300.13
- Loan Against Insurance 2240.01
- Losses of Investees 2220.12
- Minority Interest 1400.24
- Noncurrent—See Noncurrent Liabilities
- Offsetting Against Assets 1100.11
- "Pay Any Day" Loans 3200.09
- Reinsurance Contracts 6300.06
- Special Assessment Bonds 2210.14
- Unasserted Claims 6300.07
- Unclassified Balance Sheet 1100.02—03
- Unremitted Withholding Taxes 9330.01
- Valuation in a Business Combination 6110.03

LIBRARIES

- Accounting for Books 6960.06

LIFE ESTATES—See Estates**LIFE INSURANCE—See Insurance****LIMITED ASSURANCE**

- Review of Financial Statements 9600.10

LIMITED PARTNERSHIPS

- Combined Financial Statements 1400.13
- Consolidations 1400.19
- Contributed Capital 7200.07
- Disclosure of Status 7200.05
- Equity Method 1400.13; 2220.11
- Future Capital Contributions 7200.06
- Syndication Costs 7200.07

LIMITED SCOPE—See Scope Limitations**LIQUIDATION**

- Basis of Accounting 9600.13
- Disclosure of Basis 9600.13
- Financial Statement Format 9600.13
- Generally Accepted Accounting Principles 9600.13

LITIGATION

- Civil and Criminal Tax Liabilities 9320.02
- Co-owners in Divorce Suit 9320.06
- Disclosure of Possible Suit 3400.01
- Inquiry Not Sent 8340.10; 9530.09
- Settlement Due Municipality 6950.08
- Settlement Payments 3100.06
- Unstated Damages 9320.03

LOANS

- Acquisition, Development, or Construction Arrangements 6110.10
- Allowance for Loan Losses 6100.08; 6100.12
- Demand Loans to Shareholders 5220.06
- Disclosure of Contractual Maturities 6130.05
- Disclosure of Restrictive Covenants 3500.06
- Disclosure of Troubled Industries 6100.10
- Employer's Loan to Employees' Stock Ownership Plan 4140.06

LOANS—continued

Finance Companies	6130.07
Foreign—See Foreign Loans	
Guarantees	1400.21
Insider	6100.08; 7400.05
Origination Fee Income	6110.08
Participations	6100.08
Purchased from Other Banks	6100.08
Recognition of Income	6110.08
Revolving Credit Loans—See Revolving Credit Loans	
Small Business Investment Companies	5100.24
Sold with Servicing Rights Retained	6110.05
Violation of Agreement	9410.13

LOGGING—See Timber

LONG-TERM DEBT—See Liabilities

LOSSES

Abandoned Venture	5400.01
Actuarial—See Actuarial Gains and Losses	
Allowance for Loan Losses	6100.08
Allowances for Estimated Losses	5100.04
Capital Losses—See Capital Gains and Losses	
Carryforwards and Carrybacks	5250.03— 05, 5250.13
Contracts	
Cost-Plus-Fixed-Fee	6700.05
Expected Losses	5260.01
Covered by Grants	7300.12
Disposal of Segment	1200.03
Effect on Income Statement Title	1200.04
Foreign Loan Swaps	6100.12
Loss per Share	5500.14
Purchase Commitments	3500.04
Real Estate Venture	2220.12
Reinsurance	6300.06
Sale of Property	1300.09
Sale of Mortgage Loans	6110.05
Statement of Changes in Financial Position	1300.06
Transfer of Receivables	2130.04
Uncollectible Accounts—See Uncollectible Accounts	
Unrealized Losses on Investments	2120.02

MAILING LISTS

Capitalized at Replacement Cost	2210.09
---------------------------------------	---------

MAINTENANCE COSTS

Deferral by Public Utility	6200.01
Ski Slope	2210.07

MANAGEMENT

Commonly Managed Companies	1400.18
Computer Software Costs	5240.07
Disagreement with Auditor	9410.03
Fraud and Irregularities	8900.04
Responsibility for Financial Statements	8900.03; 9410.06

MARKET VALUE

Revaluation of Assets	2210.18
-----------------------------	---------

MATERIALITY

Assumptions Related to Annuity Funds	6960.07
Bulk Purchase of Assets	7610.09
Change in Amortization Method	5220.05
Development Stage Enterprises	5240.06
Errors or Irregularities	8220.02
Gain From Debt Restructuring	5100.29
Inventories in Public Warehouse	8320.06
Inventory Not Observed	9530.01
Loans to Officers and Directors	7400.05
Purchase Commitment Losses	3500.04
Write-off of Unamortized Goodwill	2250.05

MEASUREMENT

Departures from GAAP	9600.10
Grain Inventory	9520.04
Purchase Commitment Losses	3500.04
Revenue of Governmental Units	6950.08
Sampling Error	8220.02

MEAT PACKERS

Inventory	2140.06
-----------------	---------

MEDICARE

Claims Receivable	6400.07—09
Current Financing Payments	6400.06
Deferred Claims	6410.02
Fees of Hospital-Based Physicians	6400.04

MEMBERSHIPS

Assessment for Debt Retirement	5100.10
Excise Tax on Dues	5100.11
Indefinite Term Memberships	5100.09
Liability for Unremitted Taxes	9310.01
Life Membership Fees	5100.08
Revenue Recognition	5100.09
Unearned Revenue Classification	3600.01

MERCHANT MARINE ACT

Deferred Taxes	5250.10
----------------------	---------

MERGERS—See Business Combinations

MINORITY INTEREST

Acquisition in Business Combination	7620.06
Balance Sheet Classification	1400.24
Debt Guarantees	1400.21
Downstream Mergers	7610.01
Intercompany Transfer of Ownership	7620.03
Investment in Water Authority	6950.02
Presentation on Consolidated Statements	1400.02
Purchase by Parent or Subsidiary	7610.18

MODIFIED ACCRUAL BASIS

Revenue of Municipality	6950.08
-------------------------------	---------

MODIFIED CASH BASIS

Confirmations	8340.11
Credit Unions	6120.01
Depreciation	1500.03; 1500.05
Income Tax Expense	1500.05
Support for Modifications	1500.05

MORTGAGE BANKS

Loans Sold with Servicing Rights Retained	6110.05
--	---------

**MORTGAGES—See Noncurrent
Liabilities**

MORTUARIES—See Funeral Directors

**MUNICIPALITIES—See State and Local
Governments**

MUTUAL BANKS AND ASSOCIATIONS

Business Combinations	6110.02—04
Determination of Acquiring and Acquired Company	6110.04

**MUTUAL FUNDS—See Investment
Companies**

NAME OF FIRM—See Firm Name

NEGATIVE GOODWILL

Amortization	7610.07
--------------------	---------

NET REALIZABLE VALUE

Current Assets in Business Combination	7610.08—09
Holding Costs	6110.06
Interest Costs	6110.06
Inventory of Nonprofit Organization	7300.12
Real Estate	6110.06
Trade-ins	5100.01

NOMINAL VALUE

Assets Purchased at Nominal Prices	7300.14
Fixed Assets of Bank	6100.05

NONCURRENT ASSETS

Deposit on Equipment to Be Purchased	2230.02
Slow-Moving Inventory	2140.13
Unclassified Balance Sheet	1100.02
Valuation in Business Combination	7610.13

NONCURRENT LIABILITIES

Add-on Interest	3200.04
Amortization of Placement Fee	3200.06
Callable Convertible Debentures	5500.08
Classification of Subordinated Debt	6130.06
Convertible Debentures	5500.09
Cost of Living Adjustments	5220.02
Debt Assumed by Stockholders	3200.08;
	4160.01
Debt Issuance Costs	3200.01
Deferred Taxes	2130.02; 5250.01—02
Disaster Relief Loans	5220.04
Extinguishment of Debt	3200.06; 4160.02
Government Established Interest Rates	5220.04
Indefinitely Deferred Payables	3200.05
Industrial Revenue Bonds	2210.14
Interest—See Interest Expense	
Members' Debt Retirement Assessment	5100.10
Minority Interest	1400.24
Mortgage Payment by Seller	2210.01
Mortgage Placement Fees	3200.06; 5100.14
Notes Held in Escrow	3200.08
"Pay Any Day" Loans	3200.09
Placement Fee on Extinguished Debt	3200.06
Present Value of Annuity	3200.07; 6960.07
Refinanced Debt	3200.06
Special Assessment Bonds	2210.14
Subordinated Note With Warrants	4130.03
Unamortized Debt Discounts	3200.01—04
Unclassified Balance Sheet	1100.02

NONMONETARY TRANSACTIONS

Contributed Services	7300.07
Exchange of Common Stock for Real Estate	2210.21
Exchange of Real Estate	6600.07
Federal Home Loan Mortgage Corp. Preferred Stock	6110.09

NONPUBLIC ENTERPRISES

Condensed Financial Statements	9410.15
Earnings Per Share Information	1700.01
Prescribed Forms	9600.09—10
Prospective Financial Statements	1700.01
Review of Financial Statements	9600.10
Unaudited Financial Statements	9600.04;
	9600.09

NONRECIPROCAL TRANSFERS

Common Land of Homeowners Association	2210.11
Common Stock in Exchange for Real Estate	2210.21

NONSTATISTICAL SAMPLING

Audit Risk	8220.03
Size of Sample	8220.03
Substantive Tests	8220.03
Tolerable Error	8220.03

NOT-FOR-PROFIT ORGANIZATIONS

Accounting Policies	6935.01; 7300.17
Assets Purchased at Nominal Prices	7300.14
Authority of SOP 78-10	7300.17
CETA Grants	7300.15

NOT-FOR-PROFIT ORGANIZATIONS—continued

Changes in Financial Position	1300.07
Combined Financial Statements	6400.01—02
Contributions—See Contributions	
Custodial Funds	7300.09
Depreciation	6920.08
Donated Services	7300.07
Equipment Rented to Patients	5100.22
Equipment Replacement Funding	2210.16
Equity Method for Investments	7300.05
Funds—See Fund Accounting	
Gifts in Kind	6920.03
Gifts of Life Insurance Policies	7300.16
Grants-in-Aid	7300.08
Inventory Pricing	7300.12
Land, Future Transfer of Title	2210.13
Life Estate Retained by Donor	7300.13
Minority Housing Association	7300.02
Overhead Allocation	6960.12
Real Estate Investments	6920.09
Retirement Home Admittance Fee	5100.21
Securities Held for Life Beneficiaries	7300.06

NOTES PAYABLE—See Noncurrent Liabilities**NOTES RECEIVABLE**

Imputed Interest	2130.06
Interest Bearing Exchanged for Non-Interest Bearing	7400.06
Interest on Discounted Notes	5220.05
Mortgage Placement Fees	5100.14
Note from Reorganized Debtor	9330.02
Officer/Shareholder	7400.06
Sales of Area Franchises	6940.01

NOTES TO FINANCIAL STATEMENTS

Comparative Statements	1100.07
Compensated Absences	9320.07
Contingent Assets	1400.21
Cost-Based Appraisal of Fixed Assets	2210.23
Date of Caption	1400.17
Disposal of Segment	1200.03
Donated Services	7300.07
Equipment Replacement Funding	2210.16
Grain Stored for Others in Elevator	1100.12
Inclusion of Auditor's Opinion	9410.06
Liquidation Basis of Accounting	9600.13
Litigation Settlement Due Municipality	6950.08
Losses of Investees	2220.12
Potential Tax Liability	9320.02
Premium Deficits	6930.03
Prior Period Adjustments	6920.08
Reference to Compilation or Review Report	9600.16
Relation to Financial Statements	9600.08
Restricted Stock	4110.05
Retained Earnings of S Corporations	7910.03
Retained Earnings Transferred to Capital Stock	4230.01
S Corporations Reversal of Deferred Tax Liabilities	7910.05
Stockholder Agreements	2240.02; 3400.02;
	9390.01
Temporary Investments	2120.03
Uncertainties	9600.14

NURSING HOMES

Admittance Fee	5100.21
Cost Allocation	6410.03
Deferred Medicare Claims	6410.02
Depreciation	6410.02
Equipment Rented to Patients	5100.22

OBJECTIVITY			PENSIONS AND RETIREMENT PLANS—	
Internal Audit Staff	9520 03		continued	
OFFSET RIGHTS			Deferred Compensation for Key Personnel	5230 07
Assets and Liabilities	1100 11		Depreciation of Real Estate Investment	6935 02
Loan against Insurance	2240 01		Disclosure	9410 03
OIL COMPANIES—See Extractive Industries			Securities Held in Street Name	8310 02
OPERATING LEASES			Unit Credit Method	5230 03
"Free Rent"	5600 03		Unrealized Gains and Losses	2120 02
Property Leased from Spouse	5600 02			
Scheduled Rent Increases	5600 03		PERCENTAGE OF COMPLETION METHOD	
OPINIONS, AUDITORS'—See Auditors' Reports			Condominium Sales	6600 02
OPTIONS			Investment on Equity Method	2220 03
Acquisition of Control	1400 07		Long-Term Contracts	6700 01
Cancellation Costs	2210 04		Retained Percentages	6700 05—06
Commodity	8340 05		Short-term Contracts	6700 01
Sale with Repurchase Option	6600 03			
Stock Options—See Stock Options and Stock Purchase Plans			PERCENTAGE OF SALE LEASES	
ORGANIZATION COSTS			Income Statement Presentation	5100 16
Accounting Treatment	5240 08		Special Audit of Sales	9510 03
Costs Included	5240 08			
Definition	5240 08		PERMANENT DIFFERENCES	
Paid with Capital Stock	4110 03		Imputed Interest on Demand Loans	5220 06
ORPHANAGES			S Corporations	7910 04
Gifts in Kind	6920 03			
OTHER AUDITORS—See Reliance on Other Auditors' Reports			PERSONAL FINANCIAL STATEMENTS	
OVERHEAD			Income Taxes	1600 02
Auxiliary Enterprises of Colleges	6960 04		Personal Holding Companies	1600 01
Change in Application Method	9210 05		Real Estate	1600 02
Coal Production Royalties	6500 03		Separation of Personal and Business Matters	7100 01
College's Overhead Allocation	6960 12			
Depreciation Included in Inventory	5210 02		PERSONAL HOLDING COMPANIES	
Rebuilt Parts Inventory	2140 05		Applicability of FASB Statement No. 12	1600 01
Research and Development	5240 05			
Standard Cost Inventory Valuation	2140 09		PLANNING	
Warehousing Costs	2140 01		Audit Sampling	8220 02
			Documentation Requirements	8220 04
PAID-IN CAPITAL—See Contributed Capital			PLEDGES	
PARENT COMPANY			Allowance for Uncollectibles	6960 05
Differing Fiscal Year From Subsidiary	1400 22		Confirmation of Receivables	6920 04
Exchanges of Stock	7600 06			
Inventory Cost Method	1400 23		POLITICAL CONTRIBUTIONS—See Contributions	
PARTNERSHIPS			POOLING OF INTERESTS METHOD	
Combined with Corporation	1400 18		Abandoned Merger	7620 09
Consolidations	1400 19		Acquisition of Division	7620 08
Control by General Partners	1400 19		Assets Exchanged for Stock	7630 01
Deferred Franchise Taxes	7200 03		Assumption of Debt Securities	7620 14
Drawings in Excess of Capital	7200 01		Contingent Bailout Provisions	7620 15
General Corporate Partner	7200 05		Contingently Issued Stock	7620 13
Joint Ventures—See Joint Ventures Limited—See Limited Partnerships			Discount on Exchanged Stock	7630 02
Provision for Income Taxes	7200 02		Exchanges of Stock	7600 06
Unrealized Appreciation	2220 06		Incorporation of a Sole Proprietor	7600 07
PARTS INVENTORIES			Indirectly Owned Subsidiaries	7620 01
Observation of Inventory	8320 02		Mutual Banks and Associations	6110 02
Rebuilt Parts	2140 05		Nonvoting Stock Outstanding	7620 12
PATENTS			Related Companies	7600 06, 7620 03—07, 7620 12
Developed Internally	5240 04		Spin-off of Subsidiaries	7620 10
License Termination Fee	5100 20		Treasury Stock	7620 11, 7620 16
"PAY ANY DAY" LOANS			PREDECESSOR AUDITOR	
Financial Statement Presentation	3200 09		Inquiries From Successor	8900 02, 8900 05
PAYABLES—See Current Liabilities			PREFERRED STOCK—See Capital Stock	
PENSIONS AND RETIREMENT PLANS			PREMIUM DEFICITS	
Actuarial Gains and Losses	5230 03		Accrual of Losses	6930 03
			Disclosure	6930 03
AICPA Technical Practice Aids			PREPAID EXPENSES	
035—70			Interest on Discounted Notes	5220 05
			Reacquisition of Sales Contract	6610 02
			Stock Issued to Employee	4110 05
			PREPAID REVENUE—See Unearned Revenue	

PRESCRIBED REPORT FORMS

- . Auditors' Opinions 9110.04
- . Brokers or Dealers in Securities 9600.09
- . Departures from Established Principles 9600.10
- . Report of Comments/Recommendations 9110.04
- . Review of Financial Statements 9600.10

PRESENT VALUE

- . Annuity Liability Adjustments 6960.07
- . Deferred Compensation Contract 5230.06
- . Determination of Capital Lease Payments 3200.10
- . Example of Calculation for Annuity 3200.07
- . Facility Constructed by Municipality 2210.14
- . Government Established Interest Rates 5220.04
- . Imputed Interest Rates 3200.10; 5220.04

PRICE LEVEL ADJUSTMENTS

- . Interest Expense 5220.02

PRINCIPAL AUDITORS

- . Definition 9520.01

PRIOR PERIOD ADJUSTMENTS

- . Accounting and Review Services 9600.15
- . Correction of Error—See Error Correction
- . Depreciation Accounting Adopted 6920.08
- . Errors in Financial Statements 5300.01
- . Statement of Changes in Financial Position 1300.11

PROFIT SHARING PLANS

- . Financial Statements 6935.01

PROGRAMS, AUDIT—See Audit Programs**PROPERTY TAXES**

- . Confirmation of Taxes Receivable 6950.05
- . Special Assessment Bonds 2210.14
- . Tax Accrual Date 5100.05

PROPRIETORSHIPS

- . Consolidation with Corporation 1400.02
- . Income Tax Provision 7100.02
- . Incorporation 7600.07
- . Separation of Personal and Business Accounts 7100.01

PROSPECTIVE FINANCIAL STATEMENTS

- . Compilation Reports 9600.17
- . Differing Accounting Principles From Historical Statements 9600.17
- . Earnings Per Share Information 1700.01
- . Minimum Guidelines 1700.01
- . Nonpublic Enterprise 1700.01
- . Omission of Disclosures 9600.17

PUBLIC UTILITIES—See Regulated Industries**PUBLIC WAREHOUSES—See Warehouses****PUBLICLY TRADED COMPANIES**

- . Unaudited Financial Statements 9600.04
- . Withdrawn Public Offering 4100.07

PURCHASE METHOD

- . Acquisition of Division 7620.08
- . Goodwill—See Goodwill
- . Initiation, Consummation, and Resolution 7600.04
- . Minority Interest Acquisition 7610.18
- . Mutual Banks and Associations 6110.02—.04
- . Spin-off of Subsidiaries 7620.10
- . Valuation of Acquisition 6110.03; 7610.06—.13

PURCHASES, BULK—See Bulk Purchases**QUALIFIED OPINIONS**

- . Change in Estimate 9210.03
- . Departure from GAAP 2210.09; 2210.18; 9410.13; 9510.08
- . Economic Dependency 9390.05
- . Nonprofit Organizations 7300.17
- . Potential Tax Liabilities 9320.02
- . Scope Limitations 9410.04; 9530.07—.08
- . Statutory Reporting Requirements 9510.08
- . Uncertainties 9320.03; 9410.13; 9530.07
- . Unsettled Medicare Claims 6400.08

QUASI-REORGANIZATIONS

- . Deficit Carried Forward 4220.03
- . Definition 4220.01
- . Elimination of Deficit 4220.02—.03
- . Permanent Tax Benefits 5250.06
- . Write-Up of Assets 2210.18; 4220.01

RADIO

- . Broadcast Time 5100.02

REAL ESTATE

- . Acquisition, Development, or Construction Arrangements—See Acquisition, Development, or Construction Arrangements
- . Allocation of Costs to Parcels Sold 6610.04
- . Apartment Furnishings
- . Depreciation 5210.03
- . Appraisal Value of Inventory 6610.03
- . Commission Paid to Purchaser 2210.02
- . Condominium Sales 6600.02
- . Demolition Costs 2210.03
- . Exchange of Property 6600.07
- . Full Accrual Method 6600.04; 6610.02
- . Golf Course Depreciation 5210.05
- . Holding Costs 6110.06
- . In Exchange for Common Stock 2210.21
- . Interest Costs 6110.06
- . Investments 1400.19; 6920.09; 6935.02
- . Joint Ventures 2220.05
- . Losses in Excess of Investment 2220.12
- . Mortgage Payment by Seller 2210.01
- . Net Realizable Value 6110.06
- . Personal Financial Statements 1600.02
- . Property Held Pending Financing 7300.02
- . Recognition of Revenue 6600.04
- . Release Provisions 6600.04
- . Sale with Repurchase Option 6600.03
- . Special Assessment Bonds 2210.14
- . Statement of Changes in Financial Position 6610.01
- . Temporary Investments 6910.03
- . Title Verification 8330.01
- . Troubled Debt Restructurings 6110.06
- . Valuation 6110.06
- . Work Performed by Purchaser 6600.08
- . Zoning Change 9320.05

REAL ESTATE COMPANIES

- . Brokerage Commissions 6600.01
- . Statement of Changes in Financial Position 6610.01
- . Unclassified Balance Sheet 6610.01

REALIZABLE VALUE—See Net Realizable Value**REALIZATION**

- . Criteria 5100.25; 5100.27
- . Discounts on SBIC Loans 5100.24

REASONABLENESS

- . Allowance for Loan Losses 6100.08

RECEIVABLES

- . Accrued Interest on Doubtful Accounts 2130.01

RECEIVABLES—continued

· Change in Estimated Uncollectibles	9210.08
· Commission Income	6300.01
· Commitment Letters	5100.14
· Confirmations—See Confirmations	
· Cost-plus-fixed-fee Contracts	6700.05
· Cycle Billing	6200.02
· Disclosure of Loan Maturities	6130.05
· Disclosure of Receivables	
Transferred	2130.04
· Discounts on Long-term Loans	6130.07
· Disputed Acquisition Price	7610.14
· Employee Compensated Absences	6960.11
· Factoring	8340.01
· Installment Method	2130.04
· Intercompany Profit	1400.09
· Loans of SBIC	5100.24
· Loans to Officers and Directors	7400.05
· Medicare Claims	6400.07—09; 6410.02
· Modified Cash Basis Statements	8340.11
· Notes	5100.14; 9330.02
· Out-of-Pocket Costs	2130.05
· Pledges	6920.04; 6960.05
· Recoverable Tariffs	2130.03
· Scope Limitations	9530.01; 9530.06
· Taxes	6950.05
· Transferred with Recourse	2130.04
· Unbilled	6200.02
· Uncollectible Accounts—See Uncollectible Accounts	

RECORDS

· Audit Sampling	8220.04
------------------------	---------

RECORDS, CLIENT—See Client Records

RECOURSE TRANSACTIONS

· Holdbacks	2130.04
· Lease Sale or Assignment	5600.01
· Receivables Transferred to Bank	2130.04

REFUNDS

· Conditional Sales	5100.22
· Correction of Error	5300.01
· Deposits on Leased Equipment	3100.03
· Prior Period Adjustments	5300.01
· Sales of Area Franchises	6940.01
· Unclaimed	6300.03

REGULATED INDUSTRIES

· Cycle Billing	6200.02
· Deferral of Maintenance Costs	6200.01
· Intercompany Tax Allocation	5250.09
· Power Service Rights	6200.03

REGULATION A CORPORATIONS

· Audit Requirements	9410.01
----------------------------	---------

REGULATORY AGENCIES

· Condensed Financial Statements	9410.15
· Internal Control Reports for Broker- Dealers	6980.01
· Reports on Banks	9110.05
· Statutory Reporting Requirements	9110.04, 9510.08—09

REINSURANCE

· Accounting Treatment	6300.06
· Disclosure	6300.06
· Sales of Loss Reserves	6300.06

RELATED PARTIES

· Demand Loans to Shareholders	5220.06
· Disclosure of Owner-Manager Salary	7400.04
· Exchange of Common Stock for Real Estate	2210.21
· Extinguishment of Debt	4160.02
· Lease Sale or Assignment	5600.01
· Loans to Officers and Directors	7400.05
· Property Leased from Spouse	5600.02

RELATED PARTIES—continued

· Transfers to Entities Under Common Control	7600.08
---	---------

RELIABILITY

· Internal Control	8220.01
--------------------------	---------

RELIANCE ON OTHER AUDITORS' REPORTS

· Definition of Principal Auditor	9520.01
· Equity Method for Investments	2220.11
· Reliance on Internal Auditors	9520.03
· Responsibility to Audit Dividend Fund	9520.02
· Special Audit of Sales	9510.03

RENTAL EXPENSE

· "Free Rent" under Operating Leases	5600.03
---	---------

REORGANIZATIONS

· Write-Up of Assets	2210.18
----------------------------	---------

REPLACEMENT COST

· Business Combinations	7610.09
· Hospital Equipment Replacement	2210.16
· Inventory Purchased from Stockholder	8320.03
· Leasehold Improvements	7610.15
· Mailing Lists	2210.09

REPORTS, AUDITORS'—See Auditors' Reports

REPRESENTATION LETTERS

· Date	9430.03
· Failure to Obtain	8900.03
· Insurance Claims	8340.09

RESEARCH AND DEVELOPMENT

· Computer Software Costs	5240.07
· Development Stage Enterprises	5240.03
· Patents Developed Internally	5240.04
· Relation to Factory Overhead	5240.05
· Ski Slopes	2210.07

RESERVES

· Employee Benefit Plans	6930.02
· Future Insurance Claims	6300.04
· Holdback Accounts	2130.04
· Reinsurance Transactions	6300.06
· Uncollectible Accounts—See Uncollectible Accounts	

RESTATEMENTS

· Change from GAAP to Comprehensive Basis of Accounting	9210.10
--	---------

RESTAURANTS

· One-cent Sales	5100.07
· Valuation of Dishes	2210.08

RESTRICTED SECURITIES

· Issued to Officer	4110.05
· Method of Valuation	2220.09

RETAIL LAND SALES

· Allocation of Costs	6610.04
· Cost/Sales Ratio	6610.04
· Loss on Abandoned Project	5400.01
· Nonreciprocal Transfers	2210.11
· Reacquisition of Sales Contract	6610.02

RETAIL STORES

· Observation of Inventories	8320.05
· Percent of Sales Leases	5100.16

RETAINED EARNINGS

· Deficits—See Deficits	
· Disclosure of Components	7910.03
· Dividends—See Dividends	
· Exchanges of Stock	7600.06
· Liquidating Dividends Written off	4210.01
· Pooling of Interests Method	7600.06;
7630.01—02	
· Prior Period Adjustments	1300.11

RETAINED EARNINGS—continued

Restriction on Dividend Payments	3500.06
S Corporations	7910.04
Stock Dividends, Closely-Held Companies	4150.01, 4150.03
Stock Warrants Reacquired	4130.03
Tax Effect of Undistributed Earnings	5250.07
Transfer to Capital Stock	4230.01

RETIREMENT HOMES

Admittance Fee	5100.21
Donated Equipment Rented to Patients	5100.22

RETIREMENT PLANS—See Pensions and Retirement Plans**REVENUE**

Broadcast Time	5100.02
CETA Grants	7300.15
City Owned Hospital	6400.10, 6400.12
Colleges and Universities Summer Sessions	6960.09
Commissions—See Commissions	
Conditional Sales	5100.22
Condominium Sales	6600.02
Contracts Obtained for Others	5100.27
Development Stage Enterprises	5240.06
Discounts—See Discounts	
Employee Compensated Absences	6960.11
Excise Tax on Club Dues	5100.11
Executory Contracts	3500.01
Financing Charges—See Financing	
Foreign Loans	6100.10
Franchise Fees—See Franchises	
Free Service Contracts	5100.06
Gain on Involuntary Conversion	5400.03
Gain on Sale of Coins	6100.06
Grants Received From Public Utilities	2210.22
Hospital Supported Medical School	6400.11
Indefinite Term Memberships	5100.09
Interest—See Interest Revenue	
Joint Ventures	2220.03, 2220.05
Lease Sale or Assignment	5600.01
Life Insurance Proceeds of Officer	5400.04
Litigation Settlement in Installments	6950.08
Loan Origination Fees	6110.08
Medicare Fees of Physicians	6400.04
Members' Debt Retirement Assessment	5100.10
Membership Fees	3600.01, 5100.08—11
Mortgage Placement Fee	5100.14
Noncompetition Consideration	5100.23
One-cent Sales	5100.07
Overhead Allocation of Colleges	6960.12
Partially Completed Goods	5100.19
Parts Completed Not Shipped	5100.25
Pledges	6920.04, 6960.05
Prepaid Funeral Plans	5100.04
Private Label Sales	5100.28
Property Tax Accrual Date	5100.05
Real Estate Sales	6600.04
Recognition in Sales of Securities	5100.30
Rent	5100.16
Reserve for Insurance Claims	6300.04
Retained Percentages of Contracts	6700.06
Retirement Home Admittance Fee	5100.21
Termination of Patent License	5100.20
Trade-Ins	5100.01
Transfers Between Funds	6950.07
Unclaimed Refunds	6300.03
Unearned Revenue Classification	3600.01

REVENUE—continued

Unrealized Appreciation	2220.06
-------------------------	---------

REVIEW ENGAGEMENTS

Illustrative Inquiries	9600.02
Supplemental Information	9600.08

REVIEW OF FINANCIAL STATEMENTS

Basic Statements	9600.08
Communication With Successor Auditor	8900.05
Departures From Established Principles	9600.10
Disclosure Requirements	9600.06
Inquiries	9600.02
Limited Assurance	9600.10
Liquidation Basis of Accounting	9600.13
Marking of Pages	9600.04
Prescribed Forms	9600.10
Subsequent Auditing of Financial Statements	9600.19
Supplemental Information	9600.08

REVIEW REPORTS

Emphasis of a Matter	9600.14—15
Inconsistencies	9600.14—15
Omission of Disclosures	9600.14
Reference to Report in Financial Statement Notes	9600.16
Reissuance When Not Independent	9600.20
Subsequent Issuance of Audit Report	9600.19
Uncertainties	9600.14—15

RISK

Loan Losses	6100.08
Sampling	8220.02—05

ROYALTY AGREEMENTS

Coal Production Royalties	6500.03
Patent License Termination Fee	5100.20

S CORPORATIONS

Disclosure of Retained Earnings Components	7910.03
Dividends in Excess of Retained Earnings	7910.01
Reversal of Deferred Tax Liabilities	7910.05
Timing Differences	7910.04

SALARY EXPENSE—See Compensation**SALES**

Allocation of Land Costs	6610.04
Auto Sales Commissions	1200.01
Bargain—See Bargain Sales	
Conditional Sales	5100.22
Condominiums	6600.02
Discounts—See Discounts	
Export—See Export Sales	
Franchises	6940.01
Lease Sale or Assignment	5600.01
Nonprofit Scientific Corporation	7300.12
One-cent Sales	5100.07
Option to Repurchase	6600.03
Parts Completed Not Shipped	5100.25
Percentage-of-Sales Rent	5100.16, 9510.03
Private Label Sales	5100.28
Property	1300.09
Real Estate	6600.04
Receivables Transferred to Bank	2130.04
Release Provisions	6600.04
Sale and Leaseback—See Leases	
Special Audit of Sales	9510.03
Work Performed by Purchaser	6600.08

SAMPLING

Audit—See Audit Sampling	
Nonstatistical—See Nonstatistical Sampling	
Statistical—See Statistical Sampling	

SAVINGS AND LOAN ASSOCIATIONS

Acquisition, Development, or Construction Arrangements—See Acquisition, Development, or Construction Arrangements	
Capitalization of Interest	6110 06
Federal Home Loan Mortgage Corp Preferred Stock	6110 09
Income Recognition	6110 08
Loan Origination Fees	6110 08
Mortgage Loans Sold with Servicing Rights Retained	6110 05

SCHOOLS

Cafeteria System	6950 10
Colleges—See Colleges and Universities	
Consistency in Cash Basis Statements	6950 03
School Construction Trust	9390 03
Teachers' Salaries	3100 05

SCOPE LIMITATIONS

Auditors' Request to Extend Scope	9310 03
Distinction Between Scope Limitations	9530 06
Effects on Auditor's Opinion	9530 08
Failure to Send Inquiry	9530 09
Inadequate Internal Control	9530 07
Inventories Not Observed	9410 04, 9530 01—02, 9530 06
Receivables Not Confirmed	9530 06

SECURITIES

Basis of Valuation	2120 04, 2220 07, 6920 09
Credit Unions	6120 02
Held in Street Name	8310 01—02
Mutual Fund Investments	2120 04
Personal Holding Companies	1600 01
Reliance on Bank's Custodial Report	8310 01
Restricted—See Restricted Securities	
Wash Sale by a College	5100 30

SECURITIES AND EXCHANGE COMMISSION

Audit Requirements	9410 01
Fair Value of Capital Stock	4110 03
Internal Control Reports for Broker-Dealers	6980 01
Internal Control Reports for Stock Transfer Agents	9110 05
Mandatory Redeemable Preferred Stock	4110 08
Quasi-Reorganizations	4220 01, 4220 03

SECURITIES DEALERS—See Brokerage Firms

SEGMENTS OF A BUSINESS

Decision to Discontinue Reversed	1200 03
----------------------------------	---------

SELLING EXPENSES

Coal Production Royalties	6500 03
Cost Allocation	5240 01
Franchisors	6940 01
Free Service Discount	5100 06
One-cent Sales	5100 07
Prepaid Funeral Plans	5100 04
Real Estate Broker	6600 01
Warehousing Costs	2140 01

SERVICE FEES

Applicability of SFAS 65	6110 05
Sales of Receivables	6110 05

SHIPBUILDERS

Tax-Exempt Shipbuilding Fund	5250 10
------------------------------	---------

SINGLE AUDIT ACT OF 1984

Audit Requirements	6955 02
Audit Scope	6955 02

SINGLE AUDIT ACT OF 1984—continued

Auditors' Reports	6955 04
Compliance With Laws and Regulations	6955 02
Entities Covered by Act	6955 01
Frequency of Audits	6955 05
Internal Control	6955 02—03, 6955 07

SKI SLOPE

Development Costs	2210 07
-------------------	---------

SMALL BUSINESS ADMINISTRATION

Account Classification	5100 24
Disaster Relief Loans	5220 04

SMALL BUSINESS INVESTMENT COMPANIES

Equity Method for Investments	2220 07
Loan Discounts Revenue	5100 24

SOFTWARE—See Computer Software

SPECIAL REPORTS

Bank Directors' Examination	9510 10
Brokers or Dealers in Securities	9600 09
Cash Basis—See Cash Basis	
Cash Receipts and Disbursements	9510 07
Comments and Recommendations	
Reports	9110 04, 9390 03
Date of Directors' Examination	6100 01
Modified Cash Basis	1500 03, 1500 05
Sales Audit	9510 03
Statements Using Differing Methods	9510 01
Statutory Reporting Requirements	9510 09

STANDARD COSTS

Inventory Valuation	2140 09
---------------------	---------

STATE AND LOCAL GOVERNMENTS

Appropriations to Support Education	6400 11
Bond Issuance for City Owned Hospital	6400 12
Changes in Financial Position	1300 07
Combined Financial Statements	6950 11
Compensated Absences	9320 07
Compliance Reports—See Compliance Reports	
Confirmation of Taxes Receivables	6950 05
Department of Education	9510 09
Departures from Audit Guide	6960 01
Inadequate Records of Fixed Assets	6950 09
Indian Tribes	6950 01
Inventory Observed by State Inspectors	9520 04
Investment in Water Authority	6950 02
Modified Accrual Basis for Revenue	6950 08
Municipal Utility	6950 12
Municipality Financed Facility	2210 14
Prescribed Forms—See Prescribed Report Forms	
Property Sold at Nominal Prices	7300 14
Property Tax Accrual Date	5100 05
Real Estate Zoning Change	9320 05
School Cafeteria System	6950 10
School Construction Trust	9390 03
School District's Statements	6950 03
Single Audit Act of 1984	6955 01—07
Statutory Reporting Requirements	9110 04, 9510 08—09
Transfers Between Funds	6950 07

STATEMENT OF CHANGES IN FINANCIAL POSITION

Basic Financial Statement	9600 08
Cash Flow Statements	1300 02, 6610 01
Change in Depreciation Method	1300 08

STATEMENT OF CHANGES IN**FINANCIAL POSITION—continued**

- Changes Not Affecting Working Capital 1300.08
- Comparative Statements 1300.03—04
- Disclaimer of Opinion 9410.04
- Elements of Working Capital 1300.04
- Flexibility of Statement 6610.01
- Liquidation Basis of Accounting 9600.13
- Loss from Operations 1300.06
- Notes—See Notes to Financial Statements
- Not-for-profit Organizations 1300.07
- Omitted from Financial Statements 1300.05; 1300.07; 1300.10
- Prior Period Adjustments 1300.11
- Reclassification of Assets 2210.12
- Sale of Property 1300.09
- Title of Statement 1300.01—02

STATEMENT OF FINANCIAL POSITION—**See Balance Sheet****STATEMENT OF INCOME—See Income Statement****STATEMENT OF RETAINED EARNINGS**

- Basic Financial Statement 9600.08
- Liquidation Basis of Accounting 9600.13

STATEMENT OF STOCKHOLDERS' EQUITY

- Basic Financial Statement 9600.08

STATISTICAL SAMPLING

- Rental Assets Verification 8330.02
- Selection of Sampling Unit 8210.02

STATUTORY REPORTING REQUIREMENTS

- Auditor's Report 9510.08—09

STOCK DIVIDENDS AND STOCK SPLITS

- Banks 6100.07
- Closely Held Corporations 4150.01; 4150.03
- Dividend Decreases Market Price 4150.02
- Earnings per Share 5500.15

STOCK OPTIONS AND STOCK PURCHASE PLANS

- Compensation Costs 4140.01—02; 4140.05
- Disclosure of Plan Not in Force 4140.02
- Disqualifying Dispositions 4140.04
- Earnings per Share 4140.02; 5500.12—14; 5500.16
- Liability to Redeem Shares 4140.03
- Measurement Date 4140.01—02
- Moving Exercise Price 4140.01
- Option Price below Market Price 4140.05
- Stockholder Agreements 2240.02; 3400.02; 9390.01
- Treasury Stock Acquisition 7620.11

STOCK TRANSFER AGENTS

- Internal Control Reports 9110.05

STOCKHOLDERS' EQUITY

- Capital Appropriations 5100.10
- Characteristics 4110.08
- Contributed Capital—See Contributed Capital
- Deficit from Purchase of Treasury Stock 2210.18; 4120.03
- Division's Financial Statements 7900.01
- Exchange of Common Stock for Preferred 4230.02
- Exchange of Common Stock for Real Estate 2210.21
- Exchanges Between Commonly Controlled Companies 7600.06
- Mandatory Redeemable Preferred Stock 4110.08
- Minority Interest—See Minority Interest

STOCKHOLDERS' EQUITY—continued

- Obligation of Employee Stock Ownership Plans 4140.06
- Paid-in Capital Combined with Deficit 4220.02—03
- Patronage Dividend Certificates 4210.03
- Quasi-Reorganizations—See Quasi-Reorganizations
- Restricted Stock 4110.05
- Retained Earnings Transferred to Capital Stock 4230.01
- Stock Dividends for Banks 6100.07
- Subordinated Debt 4130.03; 6130.06

STOCKHOLDERS/OWNERS

- Agreements with Corporation 2240.02; 3400.02; 9390.01
- Exchange of Common Stock for Preferred 4230.02
- Exchange of Real Estate for Common Stock 2210.21
- Leases with Related Parties 5600.02

SUBSEQUENT EVENTS

- Defalcation Discovery 9330.03
- Note from Reorganized Debtor 9330.02
- Representation Letters 9430.03
- Tax Penalties 3100.04
- Unremitted Withholding Taxes 9330.01

SUBSIDIARIES—See Affiliated Companies**SUBSTANTIAL AUTHORITATIVE SUPPORT**

- Modified Cash Basis Financial Statements 1500.03; 1500.05

SUBSTANTIVE TESTS

- Audit Sampling 8220.01—02
- Nonstatistical Sampling 8220.03
- Risk of Errors 8220.03
- Sampling Risk 8220.03
- Tests of Details 8220.01

SUCCESSOR AUDITOR

- Inquiries of Predecessor 8900.02; 8900.05

SUPERMARKETS

- Percent of Sales Leases 5100.16

SUPERVISION

- Documentation Requirements 8220.04

SUPPLEMENTAL FINANCIAL INFORMATION

- Auditors' Reports 9410.14
- Compilation Engagement 9600.08
- Inventory Cost Methods 9410.12
- Review Engagement 9600.08
- S Corporations 7910.03

SUPPLIERS

- Economic Dependency of Client 9390.05

SYNDICATION COSTS

- Limited Partnerships 7200.07

SYSTEMATIC AND RATIONAL ALLOCATION

- Expense Recognition Principle 2210.15

TARIFFS

- Recoverable Tariffs Receivable 2130.03

TAX ALLOCATION

- Accelerated Cost Recovery System 2210.19; 5210.07
- Bank's Allowance for Loan Losses 6100.04
- Classification of Deferred Taxes 2130.02; 5250.01—02
- Depreciation 2210.19
- Domestic International Sales Corporations 7920.01
- Expected Loss on Contract 5260.01

TAX ALLOCATION—continued

Extraordinary Gain Exceeds Operating Loss	5250.03
Gain on Involuntary Conversion	5400.03
Installment Sales	2130.02
Intercompany Profits	1400.08; 5250.08—09; 9320.02
Investment Tax Credit	2210.19; 5250.12
Loss Carryforwards and Carrybacks	5250.03—.05; 5250.12—.13
Minimum Tax on Preference Items	6100.04
Partnership Franchise Taxes	7200.03
Permanent Tax Benefits	5250.06
Receivables Transferred to Bank	2130.04
S Corporations	7910.04—.05
Tax-Exempt Shipbuilding Fund	5250.10
Undistributed Earnings of Subsidiary	5250.07

TAX-EXEMPT ORGANIZATIONS—See Not-for-profit Organizations

TAXES

Accelerated Cost Recovery System	2210.19; 5210.07
Basis of Assets	2210.19
Capitalized During Construction	2210.07
Carryforwards and Carrybacks—See Carryforwards and Carrybacks	
Cash Basis Financial Statements	1500.03; 1500.05
Confirmation of Taxes Receivable	6950.05
Different Fiscal Year for Financial Reporting	1400.20
Economic Recovery Tax Act of 1981	5210.07
Effects of Business Combination	7610.12
Excise Tax on Club Dues	5100.11; 9310.01
Income Taxes Omitted From Interim Financial Statements	9600.21
Investment Tax Credit	2210.19; 5250.12
Modified Cash Basis	1500.03; 1500.05
New Jobs Credit	5250.11
Partners' Income Taxes	7200.02
Partnership Franchise Taxes	7200.03
Penalties	3100.04; 9320.02
Personal Financial Statements	1600.02
Political Contributions	9310.02
Property—See Property Taxes	
Prioritorship-Corporation Consolidated Statements	1400.02
Prioritorship Financial Statements	7100.02
Receivables Transferred to Bank	2130.04
S Corporations	7910.04—.05
Special Assessment Bonds	2210.14
Support of City Owned Hospital	6400.10
Tariffs—See Tariffs	
Unrecorded Tax Liability	9310.01
Unremitted Withholding Taxes	9330.01
Valuation of Capital Stock	4230.02

TELEVISION

Broadcast Time	5100.02
Cable TV Subscriptions	2250.04

TERMINOLOGY

Audit Sampling	8220.01
Block Sampling	8220.05
Current Assets	2140.13
Deposit Float	6100.11
Depreciation	5210.08
Expected Residual Profit	6110.10
Extraordinary Items	5400.04
Haphazard Sampling	8220.05
Internal Control	6955.03
Leasehold Improvements	5210.09
Marketable Equity Securities	2120.04
Organization Costs	5240.08
Random-Number Sampling	8220.05

TERMINOLOGY—continued

Sweat Equity	6110.10
Systematic Sampling	8220.05

THRIFT INSTITUTIONS

Mortgage Loans Sold with Servicing Rights Retained	6110.05
--	---------

TIMBER

Depreciation of Golf Course	5210.05
Log Pond Dredging Costs	2210.15
Ski Slope Development	2210.07
Uncertain Timber Commitment	3500.01

TIMING DIFFERENCES

Adjustments to Basis	2210.19
Deferred Taxes	2210.19; 5210.07; 5250.02; 5250.13
Depreciation	2210.19
Investment Tax Credit	2210.19
Receivables Transferred to Bank	2130.04
S Corporations	7910.04

TIRE DEALER

Observation of Inventory by Auditor	8320.05
-------------------------------------	---------

TRADE-INS

Sales Discounts	5100.01
-----------------	---------

TRANSACTIONS

Audit Tests	8220.01—.02
-------------	-------------

TRANSFER PRICING

Methods of Pricing	5240.01
--------------------	---------

TREASURY STOCK

Accounted for as an Asset	2260.01
Acquisition Prior to Merger	7620.11; 7620.16
Impairment of Legal Capital	2210.18; 4120.03
Major Stockholder Bought Out	4120.02—.03
Method	5500.09

TRIAL BALANCES

Relation to Financial Statements	9600.03
----------------------------------	---------

TRUSTS

Cemetery Perpetual Care	7500.01
Income Trust Corpus as Assets	7500.01
Indenture Compliance Audit	9390.03
Prepaid Funeral Plans	5100.04
Securities Held for Life Beneficiaries	7300.06
Trust-Trustee Transactions	9390.03

TUXEDO RENTALS

Depreciation	5210.04
--------------	---------

UNAUDITED FINANCIAL STATEMENTS

Compiled—See Compilation of Financial Statements	
Confirmation Request Forms	8340.06
Dates on Cover	9900.03
Disclaimers—See Disclaimers of Opinion	
Marking of Pages	9600.04
Nonpublic Entities	9600.10
Prescribed Forms	9600.09—.10
Reviewed—See Review of Financial Statements	
Supplemental Financial Information	9410.12

UNCERTAINTIES

Compensated Absences	9320.07
Co-owners in Divorce Suit	9320.06
Disclosure	9600.14—.15
Going Concern	9320.08; 9390.05; 9410.02; 9600.14—.15
Litigation	9320.03
Medicare Claims	6400.08—.09
Potential Tax Liability	9320.02
Real Estate Zoning Change	9320.05

UNCERTAINTIES—continued

- . Unremitted Withholding Taxes 9330.01
- . Violation of Debt Agreement 9410.13

UNCOLLECTIBLE ACCOUNTS

- . Accrued Interest 2130.01
- . Bank's Allowance for Loan Losses 6100.04; 6100.08
- . Change in Accounting Estimate 9210.08
- . Cost-plus-fixed-fee Contracts 6700.05
- . Disallowed Medicare Claims 6400.07; 6400.09
- . Out-of-Pocket Costs 2130.05
- . Pledges Receivable 6960.05
- . Receivables Transferred to Bank 2130.04
- . Subsequent Events 9330.02

UNDERWRITING DEFICITS—See**Premium Deficits****UNEARNED REVENUE**

- . Classification 3600.01
- . Discounts on SBIC Loans 5100.24
- . Franchise Fees 6940.01
- . Funeral Plans 5100.04
- . Lease Assignment Fees 5600.01
- . Reserve for Insurance Claims 6300.04

UNEEMPLOYMENT INSURANCE

- . Estimated Claims 3100.01

UNIT CREDIT METHOD

- . Actuarial Gains and Losses 5230.03

UNQUALIFIED OPINION

- . Effect of Tolerable Error 8220.02

UNUSUAL ITEMS

- . Gain on Sale of Coins 6100.06

VALUATION

- . Allocation of Land Costs 6610.04
- . Appraisal—See Appraisal Value
- . Asset Write-Up in Quasi-Reorganization 2210.18; 4220.01
- . Assets Purchased at Nominal Prices 7300.14
- . Assets Purchased in a Business Combination 6110.03
- . Bank's Assets at Nominal Value 6100.05
- . Bulk Purchases 7610.09; 7610.19
- . Business Combinations—See Business Combinations
- . Cost-Based Appraisal of Fixed Assets 2210.23
- . Exchange of Real Estate 6600.07
- . Fair Value—See Fair Value
- . Fixed Assets of City 6950.09
- . Gifts in Kind 6920.03; 7300.13
- . Good Faith Value 6910.03
- . Historically Based Appraisal Values 6960.02
- . Inventories—See Inventories
- . Investment Company Securities 2120.04; 6910.01
- . Investment in Real Estate 6910.03; 6920.09
- . Library Books 6960.06
- . Life Insurance Policies 7300.16

VALUATION—continued

- . Market—See Market Value
- . Meat Packers' Inventories 2140.06
- . Mutual Fund Investments 2120.04
- . Nominal Value—See Nominal Value
- . Nonreciprocal Transfers 2210.11; 2210.21
- . Obsolete Inventory 2140.02—03
- . Push-Down Accounting 7610.19
- . Quasi-Reorganizations 2210.18; 4220.01—03
- . Reacquired Sales Contract 6610.02
- . Securities 2220.07; 6920.09
- . Step Up in Basis of Assets 7610.19
- . Stock Dividends—See Stock Dividends and Stock Splits
- . Temporary Investments 2120.03
- . Trade-ins 5100.01
- . Unregistered Stock 2220.09
- . Write-Ups—See Write-Ups

VENDING MACHINES

- . Control of Cash Receipts 8200.02

VENTURES—See Joint Ventures**VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS—See Not-for-Profit Organizations****WAREHOUSES**

- . Grain Elevator 1100.12
- . Inventories in Public Warehouse 1100.12; 8320.06
- . Warehousing Costs in Inventory 2140.01

WARRANTS

- . Business Combinations 7620.16
- . Earnings per Share 5500.11
- . Reacquired 4130.03

WEIGHTED AVERAGE SHARES

- . Interim Periods 5500.03

WORK IN PROCESS

- . Sale of Partially Completed Goods 5100.19

WORKING CAPITAL

- . Elements of Working Capital 1300.04
- . Prior Period Adjustments 1300.11
- . Restrictive Covenants 3500.06

WORKING PAPERS

- . Documentation Requirements 8220.04
- . Stockholders' Equity 4230.01

WRITE-DOWNS

- . Quasi-Reorganizations 4220.01

WRITE-OFFS

- . Deficit After Quasi-Reorganization 4220.03
- . Landfill Rights 6700.10
- . Unamortized Goodwill 2250.05
- . Uncollectible Accounts 2130.05

WRITE-UPS

- . Asset Revaluation 2210.18
- . Quasi-Reorganizations 4220.01

ZERO COUPON BONDS

- . Accounting Treatment 5100.31
- . Amortization of Interest Income 5100.31

STATEMENTS OF POSITION ACCOUNTING STANDARDS DIVISION

Introduction

Statements of Position of the Accounting Standards Division are issued to influence the development of accounting standards in directions the Division believes are in the public interest and, in certain circumstances, to propose revisions or clarifications to recommendations on accounting standards contained in industry-oriented Audit Guides and Accounting Guides published by the American Institute of Certified Public Accountants. Statements of Position of the Accounting Standards Division do not establish standards enforceable under the Code of Professional Ethics of the American Institute of Certified Public Accountants.

Statement on Auditing Standards No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by Statement on Auditing Standards No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA Statements of Position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in the Statements of Position.

In September 1979, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters* (as amended by Statement of Financial Accounting Standards No. 83, *Designation of AICPA Guides and Statement of Position on Accounting by Brokers and Dealers in Securities, by Employee Benefit Plans, and by Banks as Preferable for Purposes of Applying APB Opinion 20*), an amendment of APB Opinion No. 20, *Accounting Changes*. This Statement specifies that the specialized accounting and reporting principles and practices contained in designated AICPA Statements of Position are preferable accounting principles for purposes of applying APB Opinion No. 20.

➡ The next page is 16,501. ←

ACC Section 10,000

STATEMENTS OF POSITION ACCOUNTING STANDARDS DIVISION

TABLE OF CONTENTS

Section	Paragraph
[10,010] Recognition of Profit on Sales of Receivables With Recourse (SOP 74-6) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 77, <i>Reporting by Transferors for Transfers of Receivables with Recourse</i>]	
10,020 Financial Accounting and Reporting by Colleges and Universities (SOP 74-8)	
Letter to Chairman, Financial Accounting Standards Board, dated August 31, 1974 (page 16,851)	
Background Information . . . . .	.01-.06
Recommendation . . . . .	.07-.09
Chapter 5:2, Current Funds, <i>College and University Business Administration</i> . . . . .	.10
Chapter 5:7, Illustrative Exhibits, <i>College and University Business Administration</i> . . . . .	.11
Chapter 5:6, Chart of Accounts, <i>College and University Business Administration</i> . . . . .	.12
10,030 Financial Accounting and Reporting by Face-Amount Certificate Companies (SOP 74-11)	
Letter to Chairman, Financial Accounting Standards Board, dated December 10, 1974 (page 17,151)	
Background Information . . . . .	.01-.04
Recommendation . . . . .	.05-.06
Reasons for Recommendations . . . . .	.07-.08
[10,040] Accounting Practices in the Mortgage Banking Industry (SOP 74-12) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 65, <i>Accounting for Certain Mortgage Banking Activities</i>]	

Section	Paragraph
[10,050] Revenue Recognition When Right of Return Exists (SOP 75-1) [Withdrawn in July 1981, by the issuance of Statement of Financial Accounting Standards No. 48, <i>Revenue Recognition When Right of Return Exists</i>]	
10,060 Accounting Practices of Real Estate Investment Trusts (SOP 75-2)	
Letter to Chairman, Financial Accounting Standards Board, dated June 27, 1975 (page 17,901)	
Introduction . . . . .	.01-.07
Losses from Loans . . . . .	.08-.29
Assets Affected by Troubled Debt Restructurings . . .	.29A-.29C
Discontinuance of Interest Revenue Recognition . . . .	.30-.38
Commitment Fees . . . . .	.39-.46
Operating Support of the REIT by the Adviser . . . . .	.47-.52
Appendixes:	
A. Illustration of accounting by a REIT for a loan on a project in the development stage . . . . .	.53
B. Illustration of accounting by a REIT on a completed multi-unit apartment project in the rent-up stage . . . . .	.54
C. Present value factors . . . . .	.55
[10,070] Accrual of Revenues and Expenditures by State and Local Governmental Units (SOP 75-3) [Superseded by the AICPA Audit and Accounting Guide, <i>Audits of State and Local Governmental Units</i> , 1986]	
[10,080] Presentation and Disclosure of Financial Forecasts (SOP 75-4) [Superseded by the AICPA Guide for <i>Prospective Financial Statements</i> , 1986]	
[10,090] Accounting Practices in the Broadcasting Industry (SOP 75-5) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 63, <i>Financial Reporting by Broadcasters</i>]	

Section	Paragraph
[10,100] Questions Concerning Profit Recognition on Sales of Real Estate (SOP 75-6) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 66, <i>Accounting for Sales of Real Estate</i>]	
[10,110] Accounting Practices in the Record and Music Industry (SOP 76-1) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 50, <i>Financial Reporting in the Record and Music Industry</i>]	
[10,120] Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry (SOP 76-2) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 65, <i>Accounting for Certain Mortgage Banking Activities</i>]	
10,130 Accounting Practices for Certain Employee Stock Ownership Plans (SOP 76-3)	
Letter to Chairman, Financial Accounting Standards Board, dated December 20, 1976 (page 18,231)	
Introduction . . . . .	.01-.04
Accounting for an Obligation of an ESOP Guaranteed by the Employer . . . . .	.05-.08
Recording an ESOP's Obligation in the Employer's Financial Statements . . . . .	.05-.06
Recording the Offsetting Debit to the Recorded Liability . . . . .	.07
Reducing the Recorded Liability . . . . .	.08
Measuring Compensation Expense . . . . .	.09-.10
Reporting Dividends Paid and Earnings Per Share . . .	.11-.13
Other Matters . . . . .	.14-.15
Investment Tax Credit . . . . .	.14
Applicability of APB Opinion No. 11 . . . . .	.15
10,140 Financial Accounting and Reporting by Investment Companies (SOP 77-1)	
Letter to Chairman, Financial Accounting Standards Board, dated April 15, 1977 (page 18,261)	
Introduction . . . . .	.01-.03
Money-Market Funds . . . . .	.04-.20

Section	Paragraph
10,140 Financial Accounting and Reporting by Investment Companies—Continued	
Background .....	.04-.05
Distribution Policies .....	.06-.08
Statement of Changes in Net Assets .....	.09-.13
Supplementary Information .....	.14-.17
Reporting Gains and Losses .....	.18-.19
Federal Income Taxes .....	.20
Put and Call Options .....	.21-.37
Background .....	.21
Option Trading .....	.22
Option Writing .....	.23-.27
Accounting .....	.28-.33
Federal Income Taxes .....	.34-.37
Expenses During the Development Stage .....	.38-.43
Amortization of Deferred Costs .....	.44-.45
Valuation of Short-Term Investments .....	.46
[10,150] Accounting of Interfund Transfers of State and Local Governmental Units (SOP 77-2) [Superseded by the AICPA Audit and Accounting Guide, <i>Audits of State and Local Governmental Units</i> , 1986]	
10,160 Accounting by Hospitals for Certain Marketable Equity Securities (SOP 78-1)	
Letter to Chairman, Financial Accounting Standards Board, dated May 1, 1978 (page 18,321)	
Accounting for Certain Marketable Equity Securities ..	.03-.16
Transition .....	.17
10,170 Accounting Practices of Real Estate Investment Trusts (SOP 78-2)	
Letter to Chairman, Financial Accounting Standards Board, dated May 12, 1978 (page 18,351)	
Introduction .....	.01-.04
The Division's Conclusions .....	.05-.06
[10,180] Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects (SOP 78-3) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 67, <i>Accounting for Costs and Initial Rental Operations of Real Estate Projects</i>]	

Section	Paragraph
[10,190]	Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate (SOP 78-4) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 66, <i>Accounting for Sales of Real Estate</i>]
[10,200]	Accounting for Advance Refunding of Tax-Exempt Debt (SOP 78-5) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 76, <i>Extinguishment of Debt</i>]
[10,210]	Accounting for Property and Liability Insurance Companies (SOP 78-6) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 60, <i>Accounting and Reporting by Insurance Enterprises</i>]
[10,220]	Financial Accounting and Reporting by Hospitals Operated by a Governmental Unit (SOP 78-7) [Superseded by the AICPA Audit and Accounting Guide, <i>Audits of State and Local Governmental Units</i> , 1986]
[10,230]	Accounting for Product Financing Arrangements (SOP 78-8) [Withdrawn in July 1981, by the issuance of Statement of Financial Accounting Standards No. 49, <i>Accounting for Product Financing Arrangements</i>]
10,240	Accounting for Investments in Real Estate Ventures (SOP 78-9)
	Letter to Chairman, Financial Accounting Standards Board, dated December 29, 1978 (page 18,545)
	Introduction01-.03
	The Applicability of the Equity Method of Accounting . .04-.11
	Corporate Joint Ventures04-.05
	General Partnerships06-.07
	Limited Partnerships08-.10
	Undivided Interests11
	General Matters12-13

<i>Section</i>	<i>Paragraph</i>
10,240 Accounting for Investments in Real Estate Ventures— Continued	
Disclosure . . . . .	.12
Statement of Changes in Financial Position . . . .	.13
Investor Accounting for Losses . . . . .	.14-.20
General . . . . .	.14
Accounting for an Investor's Share of Losses in Excess of Its Investment, Including Loans and Advances . . . . .	.15-.19
Loss in Value of an Investment, Including Loans and Advances, Other Than a Temporary De- cline . . . . .	.20
Other Accounting Matters Related to the Use of the Equity Method . . . . .	.21-.28
Eliminating Interentity Profits and Losses . . . .	.21-.23
Accounting Principles Used by the Venture . . . .	.24
Allocation Ratios for the Determination of Investor Income . . . . .	.25
Accounting for a Difference Between the Carry- ing Amount of an Investment in a Real Estate Venture and the Underlying Equity in Net Assets . . . . .	.26-.28
Accounting by the Investor for Certain Transactions with a Real Estate Venture . . . . .	.29-.38
Capital Contributions . . . . .	.29-.32
Income from Loans or Advances to a Venture . . . .	.33-.35
Sales of Real Estate to a Venture . . . . .	.36
Sales of Services to a Venture . . . . .	.37
Purchases of Real Estate or Services From a Ven- ture . . . . .	.38
Accounting for the Sale of an Interest in a Real Estate Venture . . . . .	.39-.40
Transition . . . . .	.41
10,250 Accounting Principles and Reporting Practices for Certain Nonprofit Organizations (SOP 78-10)	
Introduction . . . . .	.001-.007
Users of Financial Statements . . . . .	.008-.010
Accrual Basis of Accounting . . . . .	.011-.013
Fund Accounting . . . . .	.014-.015
Basic Financial Statements . . . . .	.016-.041
Balance Sheet . . . . .	.019-.024
Statement of Activity . . . . .	.025-.031
Statement of Changes in Financial Position . . . .	.032-.034

Section	Paragraph
10,250 Accounting Principles and Reporting Practices for Certain Nonprofit Organizations—Continued	
Other Types of Fund Classifications . . . . .	.035
Columnar vs. Layered Presentation . . . . .	.036
Totals of All Funds . . . . .	.037-.040
Comparative Financial Statements . . . . .	.041
Financially Interrelated Organizations . . . . .	.042-.049
Related-Party Transactions . . . . .	.049
Revenue, Support, and Capital Additions . . . . .	.050-.084
Capital Additions . . . . .	.051-.053
Current Restricted Gifts, Grants, Bequests, and Other Income . . . . .	.054-.062
Unrestricted Gifts, Grants, and Bequests . . . . .	.063
Pledges . . . . .	.064-.066
Donated and Contributed Services . . . . .	.067-.070
Donated Materials and Facilities . . . . .	.071
Investment Income and Gains and Losses . . . . .	.072-.076
Carrying Amount of Investments . . . . .	.077-.083
Subscription and Membership Income . . . . .	.084
Expenses . . . . .	.085-.104
Functional Classification of Expenses . . . . .	.085-.088
Program Services . . . . .	.089-.090
Management and General Costs . . . . .	.091
Fund-Raising and Other Supporting Services . . . . .	.092-.097
Allocation of Costs That Pertain to Various Functions . . . . .	.098-.100
Grants . . . . .	.101-.102
Tax Allocation . . . . .	.103
Transfers . . . . .	.104
Balance Sheet . . . . .	.105-.123
Fixed Assets . . . . .	.105
Depreciation . . . . .	.106-.112
Collections . . . . .	.113-.115
Investment Pools . . . . .	.116-.117
Interfund Borrowings . . . . .	.118-.119
Designations of Fund Balances . . . . .	.120
Other Funds . . . . .	.121-.123
Transition . . . . .	.124-.125
Appendix A: Glossary . . . . .	.126
Appendix B: Illustrative Allocation Procedures Under Paragraph .100 . . . . .	.127
Appendix C: Illustrative Financial Statements . . . . .	.128-.141

Section	Paragraph
10,260	Accounting for Municipal Bond Funds (SOP 79-1)
Definition of and Market for Municipal Bonds and Notes . . . . .	.04-.09
Municipal Bonds . . . . .	.04-.07
Municipal Notes . . . . .	.08
Market . . . . .	.09
Portfolio Investments . . . . .	.10-.28
Valuation . . . . .	.10-.11
Determining Market Value . . . . .	.12-.15
Fair Value and Matrix Pricing Methods . . . . .	.16-.18
"When Issued" Securities . . . . .	.19-.20
Portfolio Insurance . . . . .	.21-.25
Presentation . . . . .	.26-.28
Tax and Other Considerations . . . . .	.29-.39
Qualification as a Regulated Investment Company . . . . .	.29-.32
Equalization . . . . .	.33-.34
Distribution Requirements . . . . .	.35-.36
Distribution Policies . . . . .	.37-.38
Allocation of Expenses . . . . .	.39
Transition . . . . .	.40
[10,270]	Accounting by Cable Television Companies (SOP 79-2) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 51, <i>Financial Reporting by Cable Television Companies</i>]
[10,280]	Accounting for Investments of Stock Life Insurance Companies (SOP 79-3) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 60, <i>Accounting and Reporting by Insurance Enterprises</i>]
[10,290]	Accounting for Motion Picture Films (SOP 79-4) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 53, <i>Financial Reporting by Producers and Distributors of Motion Picture Films</i>]
[10,300]	Accounting for Title Insurance Companies (SOP 80-1) [Withdrawn in August 1985, by the issuance of Statements of Financial Accounting Standards Nos. 60, <i>Accounting and Reporting by Insurance Enterprises</i> , and 61, <i>Accounting for Title Plant</i>]

Section	Paragraph
[10,310] Accounting and Financial Reporting by Governmental Units (SOP 80-2) [Superseded by the AICPA Audit and Accounting Guide, <i>Audits of State and Local Governmental Units</i> , 1986]	
[10,320] Accounting for Real Estate Acquisition, Development, and Construction Costs (SOP 80-3) [Withdrawn in August 1985, by the issuance of Statement of Financial Accounting Standards No. 67, <i>Accounting for Costs and Initial Rental Operations of Real Estate Projects</i>]	
10,330 Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1)	
Introduction . . . . .	.01-.10
The Basic Accounting Issue . . . . .	.02
Present Accounting Requirements and Practices . . . . .	.03-.06
Other Pronouncements and Regulations Affecting Contract Accounting . . . . .	.07-.09
Need for Guidance . . . . .	.10
Scope of Statement of Position . . . . .	.11-.20
Contracts Covered . . . . .	.12-.15
Definition of a Contractor . . . . .	.16
Definition of a Profit Center . . . . .	.17
Application and Effect on Existing Audit Guides and SOPs . . . . .	.18-.20
The Division's Conclusions . . . . .	.21-.91
Determining a Basic Accounting Policy for Contracts . . . . .	.21
The Percentage-of-Completion Method . . . . .	.22-.29
Circumstances Appropriate to the Method . . . . .	.23-.25
Nature of Reasonable Estimates and Inherent Hazards . . . . .	.26-.29
The Completed-Contract Method . . . . .	.30-.33
Circumstances of Use . . . . .	.31-.33
Determining the Profit Center . . . . .	.34-.42
Combining Contracts . . . . .	.35-.38
Segmenting a Contract . . . . .	.39-.42
Measuring Progress on Contracts . . . . .	.43-.52
Methods of Measuring Extent of Progress Toward Completion . . . . .	.44-.45
Input and Output Measures . . . . .	.46-.51
Completion Criteria Under the Completed-Contract Method . . . . .	.52
Income Determination—Revenue Elements . . . . .	.53-.67
Basic Contract Price—General . . . . .	.55-.56

<i>Section</i>	<i>Paragraph</i>
10,330 Accounting for Performance of Construction-Type and Certain Production-Type Contracts—Continued	
Basic Contract Price—Cost-Type Contracts	.57-.59
Customer-Furnished Materials . . . . .	.60
Change Orders . . . . .	.61-.63
Contract Options and Additions . . . . .	.64
Claims . . . . .	.65-.67
Income Determination—Cost Elements . . . . .	.68-.78
Contract Costs . . . . .	.69-.72
Precontract Costs . . . . .	.73-.75
Cost Adjustments Arising from Back Charges . . . . .	.76-.77
Estimated Cost to Complete . . . . .	.78
Computation of Income Earned for a Period Under the Percentage-of-Completion Method . . . . .	.79-.81
Alternative A . . . . .	.80
Alternative B . . . . .	.81
Revised Estimates . . . . .	.82-.84
Provisions for Anticipated Losses on Contracts . . . . .	.85-.89
Transition . . . . .	.90-.91
Appendix A—Schematic Chart of SOP Organization	.92
Appendix B—Types of Contracts . . . . .	.93
Appendix C—Summary of Disclosure Recommendations in Statement of Position . . . . .	.94
10,340 Reporting Practices Concerning Hospital-Related Organizations (SOP 81-2)	
Subcommittee's Conclusions . . . . .	.07-.12
Transition . . . . .	.13
Appendix A . . . . .	.14
Appendix B . . . . .	.15
Appendix C . . . . .	.16
10,350 Accounting and Financial Reporting for Personal Financial Statements (SOP 82-1)	
Introduction . . . . .	.01-.02
Basis of Presentation of Personal Financial Statements . . . . .	.03-.04
Presentation of Personal Financial Statements . . . . .	.05-.11
The Reporting Entity . . . . .	.05
The Form of the Statements . . . . .	.06
The Methods of Presentation . . . . .	.07-.11
Guidelines for Determining the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities . . . . .	.12-.30

Section		Paragraph
10,350	Accounting and Financial Reporting for Personal Financial Statements—Continued	
	General .....	.12-.15
	Receivables .....	.16
	Marketable Securities .....	.17-.19
	Options .....	.20
	Investment in Life Insurance .....	.21
	Investments in Closely Held Businesses .....	.22-.23
	Real Estate (Including Leaseholds) .....	.24
	Intangible Assets .....	.25
	Future Interests and Similar Assets .....	.26
	Payables and Other Liabilities .....	.27
	Noncancellable Commitments .....	.28
	Income Taxes Payable .....	.29
	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
	Financial Statement Disclosures .....	.31-.32
	Transition and Effective Date .....	.33
	Appendix A—Illustrative Financial Statements .....	.34
	Appendix B—Computing the Excess of the Esti- mated Current Values of Assets Over Their Tax Bases and the Estimated Income Taxes on the Excess .....	.35
10,360	Reporting by Banks Of Investment Securities Gains or Losses (SOP 83-1)	
	Background .....	.01-.05
	Rationale for the Two-Step Format .....	.06-.10
	Rationale for the One-Step Format .....	.11-.15
	Recommendations of the Banking Committee .....	.16
	Rationale for the Recommendations .....	.17
	Effective Date and Transition .....	.18
10,370	Financial Reporting by Not-for-Profit Health Care Entities for Tax-Exempt Debt and Cer- tain Funds Whose Use Is Limited (SOP 85-1)	
	Introduction and Scope .....	.01-.06
	Definitions .....	.07-.10
	The Basic Issues .....	.11
	Diversity in Practice .....	.12-.15
	Views on the Issues .....	.16-.22
	Classifying the Debt .....	.16
	Classifying Assets Whose Use Is Limited .....	.17-.19
	Presenting Investment Income and Expense .....	.20-.22

<i>Section</i>	<i>Paragraph</i>
10,370 Financial Reporting by Not-for-Profit Health Care Entities for Tax-Exempt Debt and Certain Funds Whose Use Is Limited—Continued	
Conclusions . . . . .	.23
Effective Date and Transition . . . . .	.24
Appendix—Illustrative Financial Statements . . . . .	.25
 10,380 Accounting for Dollar Repurchase—Dollar Reverse Repurchase Agreements by Sellers-Borrowers (SOP 85-2)	
Introduction . . . . .	.01-.09
Scope . . . . .	.10-12
Present Accounting Practices . . . . .	.13-28
Repurchase—Reverse Repurchase Agreements . . . . .	.13-14
Dollar Repurchase—Dollar Reverse Repurchase Agreements . . . . .	.15-17
Seller-Borrower . . . . .	.18-23
Rollovers and Extensions . . . . .	.24
Breakage . . . . .	.25-28
Division's Conclusions . . . . .	.29-37
Fixed Coupon . . . . .	.30-32
Yield Maintenance . . . . .	.33-34
Rollovers and Extensions . . . . .	.35
Breakage . . . . .	.36-37
Effective Date and Transition . . . . .	.38
Appendix—Examples of Accounting for Dollar Agreements . . . . .	.39
 10,390 Accounting by Agricultural Producers and Agricultural Cooperatives (SOP 85-3)	
Introduction . . . . .	.001-.022
Definitions . . . . .	.002
Agricultural Producers . . . . .	.003-.005
Agricultural Cooperatives . . . . .	.006-.022
Accounting for Inventories of Crops by Agricultural Producers . . . . .	.023-.039
Diversity in Practice . . . . .	.026
Pros and Cons . . . . .	.027-.037
Division Conclusions . . . . .	.038-.039

Section	Paragraph
10,390 Accounting by Agricultural Producers and Agricultural Cooperatives—Continued	
Accounting for Development Costs of Land, Trees and Vines, Intermediate-Life Plants, and Animals .....	.040-.062
Diversity in Practice .....	.045-.050
Pros and Cons .....	.051-.058
Division Conclusions .....	.059-.062
Accounting for Patrons' Product Deliveries to Marketing Cooperatives Operating on a Pooling Basis .....	.063-.086
Diversity in Practice .....	.066-.072
Authoritative Literature .....	.073
Pros and Cons .....	.074-.078
Division Conclusions .....	.079-.086
Accounting for Investments in and Income From Cooperatives .....	.087-.105
Diversity in Practice .....	.088-.093
Authoritative Literature .....	.094-.095
Pros and Cons .....	.096-.102
Division Conclusions .....	.103-.105
Effective Date and Transition .....	.106
Appendix—Accounting by Pooling Cooperatives for Products Received From Patrons .....	.107
10,400 Reporting Repurchase—Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations (SOP 86-1)	
Introduction and Scope .....	.01-.04
Background .....	.05-.10
Repurchase and Reverse Repurchase Agreements .....	.05-.06
Mortgage-Backed Certificates .....	.07-.10
Current Reporting Guidance .....	.11-.16
Repurchase and Reverse Repurchase Agreements .....	.11-.16
Views on Additional Disclosure by Savings and Loan Associations .....	.17-.30
Repurchase and Reverse Repurchase Agreements .....	.17-.27
Mortgage-Backed Certificates .....	.28-.30

<i>Section</i>	<i>Paragraph</i>
10,400 Reporting Repurchase—Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations—Continued	
Recommendations . . . . .	.31-.32
Repurchase and Reverse Repurchase Agreements . . . . .	.31
Mortgage-Backed, Pass-Through Certificates . . . . .	.31-.32
Effective Date and Transition . . . . .	.33
Appendix—Illustrative Financial Statement Disclosures . . . . .	.34
 10,410 Accounting for Asserted and Unasserted Medical Malpractice Claims of Health Care Providers and Related Issues (SOP 87-1)	
Introduction . . . . .	.01-.04
Definitions . . . . .	.05
Scope . . . . .	.06-.07
Relevant Accounting Pronouncements . . . . .	.07
Accounting for Uninsured Asserted and Unasserted Malpractice Claims . . . . .	.08-.29
Discussion . . . . .	.09-12
Present Practices . . . . .	.13-16
Views on the Issues . . . . .	.17-20
Conclusions . . . . .	.21-29
Disclosure of Discounting Accrued Unpaid Malpractice Claims . . . . .	.30-.32
Discussion . . . . .	.31
Conclusions . . . . .	.32
Accounting for Claims-Made Policies and Tail Coverage . . . . .	.33-.43
Discussion . . . . .	.34-36
Present Practices . . . . .	.37-38
Views on the Issues . . . . .	.39-42
Conclusions . . . . .	.43
Accounting for Retrospectively Rated Premiums . . . . .	.44-.53
Discussion . . . . .	.45-46
Present Practices . . . . .	.47-48
Views on the Issues . . . . .	.49-51
Conclusions . . . . .	.52-53

Section		Paragraph
10,410	Accounting for Asserted and Unasserted Medical Malpractice Claims of Health Care Providers and Related Issues—Continued	
	Accounting for Medical Malpractice Claims Insured With Captive Insurance Companies . . . . .	.54-.65
	Discussion . . . . .	.55-.57
	Present Practices . . . . .	.58
	Views on the Issues . . . . .	.59-.61
	Conclusions . . . . .	.62-.65
	Accounting for Trust Funds . . . . .	.66-.75
	Discussion . . . . .	.67-.68
	Present Practices . . . . .	.69
	Views on the Issues . . . . .	.70-.72
	Conclusions . . . . .	.73-.75
	Effective Date and Transition . . . . .	.76-.77

➡ *The next page is 16,851.* ←

Section 10,020***Statement of Position 74-8
Financial Accounting and
Reporting by Colleges
and Universities*****[Proposal to Financial Accounting Standards Board to Amend
AICPA Industry Audit Guide on Audits of Colleges and Universities]****AICPA****American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

August 31, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

Proposal to Amend the
AICPA Industry Audit Guide
on Audits of Colleges and
Universities

Two recent publications on college and university financial accounting and reporting have endorsed expansion, clarification and revision of the AICPA Industry Audit Guide on Audits of Colleges and Universities (Audit Guide) in certain respects. The new publications are College and University Business Administration -- Administrative Service, published in May, 1974 by the National Association of College and University Business Officers, and Report of the Joint Accounting Group, published in March, 1974 by the Western Interstate Commission for Higher Education.

Members of the AICPA Accounting Standards Task Force on Colleges and Universities participated in a consultative capacity in the development of both publications and the Task Force has prepared the accompanying Statement of Position. Its purpose is to bring to your attention amendments to the Audit Guide recommended by the Task Force to conform the guide to the new publications and

to request that the profession be advised, by whatever means seems appropriate, whether FASB concurs with the proposed amendments.

The amendments would give effect to the revenue, expenditure, and transfer descriptions and classifications set forth in Part 5 of the Administrative Service. They would be consistent with recommendations in those respects in the Report of the Joint Accounting Group.

Issuance of this Statement of Position will help to apprise independent auditors and others who are interested in college and university accounting and financial reporting matters of the existence of the two new publications and of the recommendation of the Task Force as to the appropriate corresponding amendment of the Audit Guide. We urge, however, as a further and more conclusive step that FASB advise the accounting profession at an early date as to whether it believes the proposed amendments are appropriate and should be regarded as having the same authoritative support as if they had been included in the Audit Guide initially. A prompt indication to the profession is especially desirable in view of the extensive recent distribution of the two aforementioned publications and in anticipation that some institutions may want to adopt the revised classifications in their fiscal 1974 financial statements.

Members of the Task Force will be glad to meet with you or your representatives to discuss these proposals. It would appreciate being advised as to the Board's proposed action on its recommendations.

Sincerely yours,

ACCOUNTING STANDARDS TASK FORCE
ON COLLEGES AND UNIVERSITIES

Jay H. Anderson, Chairman
Delford W. Edens
Daniel D. Robinson
Russel F. Viehweg

➡ *The next page is 16,855.* ⬅

NOTES

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 these Guides, AICPA Task Forces 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 Task Force.

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 such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force 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 Task Force believes would be in the public interest.

AUDITS OF COLLEGES AND UNIVERSITIES

Proposed Amendment to Industry Audit Guide

BACKGROUND INFORMATION

.01 At the time of final editing of the Industry Audit Guide on *Audits of Colleges and Universities* (Audit Guide) in June, 1973, the Committee of AICPA members which prepared the Audit Guide was aware of discussions then in progress among members of the Accounting Principles Committee of the National Association of College and University Business Officers (NACUBO) and the National Center for Higher Education Management Systems (NCHEMS) concerning the classification of revenues and expenditures in higher education financial accounting and reporting. The Preface of the Audit Guide mentions that the guide was developed with the coordination and cooperation of representatives of NACUBO. Special provision for future modification of revenue, expenditures and transfer

categories was incorporated at the beginning of the chapters in the Audit Guide on current funds revenues, expenditures and transfers by inserting: "the following categories have been endorsed for current use by the National Association of College and University Business Officers."

.02 The fundamental accounting principle relating to presentation of revenues and expenditures which was adopted by the Audit Guide Committee was that *revenues should be classified by source and expenditures by function*. The Committee felt that, as long as this basic classification philosophy was adhered to, any reasonable amount of detail of revenues, expenditures and transfers desired by the industry would be agreeable to the accounting profession. The detailed categories of revenues, expenditures and transfers shown in the Audit Guide reflected the most recent recommendations of NACUBO at that time and deviated somewhat from those displayed in the 1968 revised edition of *College and University Business Administration*, or *CUBA* (1968). *CUBA* (1968) was published by the American Council on Education and, until publication of the Audit Guide by the AICPA in August 1973 and Part 5 of *College and University Business Administration—Administrative Service* (Administrative Service) by NACUBO in May 1974, was regarded as the major authoritative pronouncement on college and university accounting and financial reporting.

.03 Efforts were launched in the summer of 1969 by NACUBO to revise *CUBA* (1968). Efforts were under way at NCHEMS to prepare a Higher Education Finance Manual (HEFM), a project sponsored by the U.S. Office of Education to provide, among other things, procedures and formats for reporting financial data needed for planning and management at the institutional as well as state and federal government levels. A meeting of representatives of each of three interested groups (NACUBO, NCHEMS and AICPA) resulted in the concept of a joint effort to identify and clarify areas of difference and explore mutually satisfactory ways of developing more uniformity. The Chairman of the AICPA Committee which had developed the Audit Guide and two other members of that Committee, which officially dissolved in October, 1973, were invited to become members, along with NACUBO and NCHEMS representatives, of a new Joint Accounting Group (JAG) to carry out these objectives.

.04 JAG's work was completed with the publication by the

Western Interstate Commission for Higher Education, Boulder, Colorado, in March, 1974 of the *Report of the Joint Accounting Group*. The primary recommendation of that report was that, with the exception of current funds revenues, expenditures and transfers, higher education institutions should utilize the accounting definitions and practices outlined in the Audit Guide. The JAG report in Appendixes I and II set forth recommended revenue, expenditure and transfer category descriptions which represented a revision of those presented in the Audit Guide. The JAG also recommended that its revised revenue, expenditure and transfer categories be incorporated into the Audit Guide and the new Administrative Service. The categories recommended by the JAG were later used by NACUBO in its preparation of Part 5 of the new Administrative Service. Thus the report of the JAG was an initial step toward the inclusion of the revised revenue, expenditure and transfer categories in the new Administrative Service which the Task Force now considers more current than those included in the Audit Guide.

.05 The JAG was formed in the summer of 1973 and at the same time, at the request of officials of NACUBO, the Accounting Standards Division of the AICPA organized a Task Force, consisting of four of the members of the former Audit Guide Committee (including the three individuals participating with the JAG), to consult with NACUBO's Accounting Principles Committee regarding the revision of *CUBA* (1968). This revision was published as a section (Part 5) of the new looseleaf Administrative Service. It can be obtained by subscription from NACUBO, Suite 510, One Dupont Circle, Washington, D.C. 20036. The new Administrative Service replaces *CUBA* (1968) as the major authoritative pronouncement on college and university accounting and financial reporting published by the industry.

.06 Both the NACUBO and JAG efforts were conducted in close coordination with each other and involved overlap of representatives of AICPA, NACUBO and NCHEMS. Both of these projects involved a certain amount of refinement of revenue, expenditure, and transfer definitions and classifications. However, no deviations from the fundamental accounting principles, auditing procedures or standards of financial statement presentation from those set forth in the Audit Guide were advocated in the two publications. Neither of the publications deals at all with

auditing standards. The participation of AICPA Committee and Task Force members in these two publication efforts was geared to provide the two primary constituencies (NACUBO and NCHEMS) with background information and explanations about the content of the Audit Guide and to assist them in making sure that their publications did not deviate from the basic accounting principles and standards of financial reporting contained in the Audit Guide. Even though the JAG report and the new Administrative Service reflect different literary styles, the Task Force members who were involved in the consulting projects believe that those publications do not contain any significant deviations from the accounting principles and reporting standards reflected in the Audit Guide. The Audit Guide concept of revenues by source and expenditures by function has been followed.

RECOMMENDATION

.07 The Task Force believes that the descriptions and classifications of revenues, expenditures and transfers, as they pertain to current funds, set forth in Chapters 5:2 (Current Funds), 5:6 (Chart of Accounts) and 5:7 (Illustrative Exhibits) of the new Administrative Service should be recognized by practitioners as representing more current descriptions and classifications than those presented in the Audit Guide and that, until such time as the Audit Guide is revised, independent auditors should refer to those parts of NACUBO's new Administrative Service, which are appended to this Statement of Position, in connection with current funds revenue, expenditure and transfer account descriptions and classifications.

.08 Specifically, the Task Force believes the Audit Guide should be considered as being superseded by the Administrative Service as follows:

- a. Pages 20-24 of Chapter 5, Current Funds Revenues, of the Audit Guide, through the section on Expired Term Endowments, should be superseded by the section Current Funds Revenues beginning on Page 2 of Chapter 5:2, Current Funds, of the Administrative Service.
- b. Pages 26-30 of Chapter 6, Current Funds Expenditures and Transfers, of the Audit Guide, through the section on Other Transfers—Unrestricted Current Funds, should be superseded by the section on Current Funds Expenditures and Transfers, beginning on Page 6 of

Chapter 5:2, Current Funds, of the Administrative Service.

- c. The Illustrative Financial Statements in Exhibits A-C on Pages 60-72 of the Audit Guide should be superseded by Chapter 5:7, Illustrative Exhibits, of the Administrative Service.
- d. The section of Chapter 5:6, Chart of Accounts, of the Administrative Service, beginning with Current Funds Revenues Accounts through the end of Page 10, should be added to the Audit Guide as Appendix A.

.09 The Task Force further believes that adoption of the expanded descriptions and classifications should be effective for all fiscal years beginning after June 30, 1974 and that earlier adoption should be permissible.

➤→ *The next page is 16,863.* ←➤

.10

CURRENT FUNDS*

[Chapter 5: 2]

THE CURRENT FUNDS group includes those economic resources of a college or university which are expendable for the purpose of performing the primary missions of the institution—instruction, research, and public service—and which are not restricted by external sources or designated by the governing board for other than operating purposes. The term “current” means that the resources will be expended in the near term and that they will be used for operating purposes.

The Current Funds group has two basic subgroups—unrestricted and restricted. Unrestricted current funds include all funds received for which no stipulation was made by the donor or other external agency as to the purposes for which they should be expended. Restricted current funds are those available for financing operations but which are limited by donors and other external agencies to specific purposes, programs, departments, or schools. Externally imposed restrictions are to be contrasted with internal designations imposed by the governing board on unrestricted funds. Internal designations do not create restricted funds, inasmuch as the removal of the designation remains at the discretion of the governing board.

The distinction between unrestricted and restricted funds is maintained through the use of separately balanced groups of accounts in order to provide acceptable reporting of stewardship to donors and other external agencies. This distinction also emphasizes to governing boards and other sources of financial support the various kinds of resources of the Current Funds group that are available to meet the institution’s objectives.

Separate accounting entities may be provided for auxiliary enterprises, hospitals, and independent operations in either the Unrestricted Current Funds or Restricted Current Funds subgroup or both, as appropriate.

Assets, Liabilities, and Fund Balances of Current Funds

Assets usually consist of cash, accounts receivable, including unbilled charges, notes receivable, undrawn appropriations, in-

* From *College and University Business Administration*, third edition (Washington, D.C., 1974), by permission of the National Association of College and University Business Officers.

vestments, amounts due from other fund groups, inventories, prepaid expenses, and deferred charges. "Unbilled charges" are those which have been earned but which, because of inadequate information, incomplete projects or programs, or the timing of the billing cycle, have not been formally billed at the balance sheet date. "Undrawn appropriations" are those to which the institution is entitled, but which have not been remitted or made available to the institution by the appropriating federal, state, or local agency. "Deferred charges" are expenditures that are related to projects, programs, activities, or revenues of future fiscal periods.

Liabilities usually consist of accounts and notes payable, accrued liabilities, deposits, amounts due to other fund groups, and deferred credits. Accrued liabilities include such items as interest, wages, salaries, and taxes. Deferred credits are those revenues of unrestricted current funds that are applicable to a future period, when they become earned.

The individual assets and liabilities, but not the fund balances, of unrestricted and restricted current funds are sometimes combined for reporting purposes, but if they are combined, the borrowings between unrestricted and restricted funds should be disclosed by footnote or other appropriate means.

The fund balances may be subdivided to show allocations applicable to auxiliary enterprises, hospitals, independent operations, outstanding encumbrances, other allocations by operating management or by the governing board, budget balances brought forward from prior fiscal periods, and the unallocated balance.

Changes in the balances of unrestricted current funds include the gross amount of all unrestricted revenues and expenditures applicable to the reporting period, as determined in accordance with the accrual basis of accounting, and transfers to and from other fund groups for the period. Significant allocations of unrestricted current fund balances should be disclosed.

The fund balances of restricted current funds should be classified in the accounting system to show the various classes and sources of funds and purposes of restriction. Such restrictions often relate to the use of endowment fund income; gifts, grants, and contracts from private and governmental sources; and legislative appropriations. Further breakdowns may be provided to show amounts restricted to auxiliary enterprises, hospitals, and

independent operations, if such activities are the beneficiaries of restricted current funds.

Additions to fund balances of restricted current funds arise from the sources indicated in the preceding paragraph. Deductions from restricted fund balances result from:

1. Direct expenditures and mandatory transfers.
2. Refunds to donors and other external agencies.
3. Amounts transferred to unrestricted revenues representing indirect cost recoveries on appropriate programs.
4. Nonmandatory transfers.

Current Funds Revenues

Current funds revenues include (1) all unrestricted gifts, grants, and other resources earned during the reporting period and (2) restricted resources to the extent that such funds were expended. Current funds revenues do not include restricted current funds received but not expended or resources that are restricted by external persons or agencies to other than current funds.

Interdepartmental transactions between service departments and storerooms and other institutional departments or offices should not be reported as revenues of the service departments but rather as reductions of expenditures of such departments, since these transactions are essentially interdepartmental transfers of costs. The billed price of services and materials obtained from service departments and central stores by offices and departments of the institution should be accounted for as expenditures of those offices and departments, just as if they had been obtained from sources outside the institution. Any difference between costs and billed prices as recorded in the service department account, whether credit or debit, should be reported under the Institutional Support expenditures classification.

Certain intrainstitutional transactions, however, should be reflected in the operating statements of the institution as revenues and expenditures. Materials or services produced by an instructional department as a by-product of the instructional program and sold to other departments or to auxiliary enterprises or hospitals—for example, milk sold by the dairy department to the dining halls—should be treated as sales and services revenues

of the selling department and as expenditures of the receiving department. Sales and services of auxiliary enterprises to other departments—for example, catering by the food services department in the entertainment of institutional guests and sales by the college store to instructional departments—should be treated as sales and services revenues of the respective auxiliary enterprises and as expenditures of the unit receiving the services or materials.

Unrestricted and restricted current funds revenues should be grouped into the following major classifications by source of funds:

- Tuition and Fees
- Federal Appropriations
- State Appropriations
- Local Appropriations
- Federal Grants and Contracts
- State Grants and Contracts
- Local Grants and Contracts
- Private Gifts, Grants, and Contracts
- Endowment Income
- Sales and Services of Educational Activities
- Sales and Services of Auxiliary Enterprises
- Sales and Services of Hospitals
- Other Sources, *including expired term endowments and expired life income agreements, if not material; otherwise, separate category*
- Independent Operations

Tuition and Fees

This category should include all tuition and fees assessed against students (net of refunds) for educational purposes. Tuition and fees should be recorded as revenue even though there is no intention of collection from the student. The amounts of such remissions or waivers should be recorded as expenditures and classified as Scholarships and Fellowships or as staff benefits associated with the appropriate expenditure category to which the personnel relate.

When specific fees are assessed under binding external restrictions for other than current operating purposes—for example, debt service on educational plant or on renewals, replace-

ments, or additions to plant—they should be reported as additions to the appropriate fund group (in the above example, plant funds), since they are not legally available for current operating purposes. Fees normally are not considered as assessed under binding external restrictions unless there is an explicit representation to the individuals remitting the fees that the fee or a specific portion thereof can be used only for the specific non-operating purpose.

If some portion of total tuition or fee receipts is pledged under bond indenture agreements, the total receipts should be reported as unrestricted current funds revenues and the pledged amount treated as a mandatory transfer to plant funds.

If some portion of tuition or fees is allocated by action of the governing board, or subject to change by the governing board alone, for other than operating purposes, such as financing construction, the whole of the tuition charges or fees should be recorded as unrestricted current funds revenues and the portion allocated should be treated as a nonmandatory transfer to the appropriate fund group (in the above example, plant funds).

Revenues pledged under bond indenture agreements should not be reported as additions to plant funds, but should be reported as unrestricted current funds revenues, and funding of debt service requirements treated as mandatory transfers.

If an all-inclusive charge is made for tuition, board, room, and other services, a reasonable distribution should be made between revenues for tuition and revenues for sales and services of auxiliary enterprises.

Revenues from tuition and student fees of an academic term that encompasses two fiscal years—for example, a summer session—should be reported totally within the fiscal year in which the program is predominantly conducted.

If tuition or fees are remitted to the state as an offset to the state appropriation, the total of such tuition or fees should be deducted from the total for state appropriations and added to the total for tuition and fees.

Governmental Appropriations

This category includes (1) all unrestricted amounts received for current operations from, or made available to an institution by, legislative acts or local taxing authority and (2) restricted

amounts from those same sources to the extent expended for current operations. This category does not include governmental grants and contracts. Amounts paid directly into a state or local retirement system by the appropriating government on behalf of the college or university should be recorded as revenue of the institution. This category does not include institutional fees and other income reappropriated by the legislature to the institution.

The determination of whether a particular government appropriation should be classified as restricted or unrestricted funds is based on the ability of the governing board of the institution to effect a change in the intended use of the funds. If a change in a particular restriction can be made without having to go through the legislative process, the funds should be considered unrestricted. Funds are unrestricted even if they are distributed to the institution for purposes specified by an intermediate group, such as the governing board. In this case, if a change in the use of funds needs to be made, it can be made by the intermediate body without going through the legislative process; the funds therefore would be unrestricted. Such appropriations should be considered unrestricted funds unless the restrictions are so specific that they substantially reduce the institution's flexibility in financial operations. Appropriations in terms of major object classes or to colleges and branch institutions should be classified as unrestricted current funds.

Governmental appropriations should be classified to identify the governmental level—federal, state, or local—of the legislative body making the appropriation to the institution. The fundor level is the level of the agent that makes the decision that the moneys will be appropriated to the particular purpose for which they ultimately are expended. For example, if the federal government stipulates a specific use for some funds that merely flow through the state to the institution, the funds should be classified as federal funds. However, if the federal government distributes funds to the state for unspecified general purposes—for example, general revenue sharing—and the state then appropriates all or a portion of those funds, the funds received by the institution should be classified as state rather than federal funds.

Governmental Grants and Contracts

This category includes (1) all unrestricted amounts received or made available by grants and contracts from governmental

agencies for current operations and (2) all amounts received or made available through restricted grants and contracts to the extent expended for current operations.

Amounts equal to direct costs incurred by restricted current funds should be recorded as revenues of those funds, while amounts equal to associated indirect cost recoveries should be reported as unrestricted current funds revenues.

The government fundor level should be disclosed using the same criterion described for governmental appropriations.

Private Gifts, Grants, and Contracts

This category includes amounts from nongovernmental organizations and individuals, including funds resulting from contracting for the furnishing of goods and services of an instructional, research, or public service nature. It includes all unrestricted gifts, grants, and bequests as well as all restricted gifts, grants, and contracts from nongovernmental sources to the extent expended in the current fiscal year for current operations. Gifts, grants, and contracts from foreign governments should be treated as private gifts, grants, and contracts. Income from funds held in revocable trusts or distributable at the direction of the trustees of the trusts should be reported as a separate revenue source under this classification. This category excludes revenues derived from contracts and other activities, such as utility services, that are not related directly to instruction, research, or public service.

Amounts equal to the direct costs incurred by restricted current funds should be reported as revenues of those funds, while amounts equal to the associated indirect cost recoveries should be recorded as unrestricted current funds revenues.

Endowment Income

This category includes :

1. Unrestricted income from endowment and similar funds.
2. Restricted income from endowment and similar funds to the extent expended for current operations.
3. Income from funds held by others under irrevocable trusts, which should be identified separately under this revenue heading.

The unrestricted income from investments of endowment and

similar funds credited to unrestricted current funds revenues should be the total ordinary income earned (or yield), except for income that must be added back to the principal in accordance with the terms of the agreement of donation. If endowment fund investments include real estate, the income should be reported on a net basis after allowing for all costs of operating and managing the properties.

Income from investments of endowment and similar funds does not include capital gains and losses, since such gains and losses are accounted for in the Endowment and Similar Funds group as additions to and deductions from fund balances. If any portion of the gains of endowment or quasi-endowment funds is utilized for current operating purposes, the portion so utilized should be reported as a transfer rather than as revenue (see Chapter 5:3).

When investments of endowment and similar funds are pooled, the amounts reported as revenues of unrestricted current funds and as additions to restricted current funds should be substantially equal to the amounts earned during the fiscal period and attributable to the various funds.

Many institutions have established endowment income stabilization reserves to spread or allocate current investment income. Two methods have been followed in establishing such reserves.

Under one method, a portion of the total revenue from the investment pool is not allocated to the participating funds, but is set aside in a stabilization reserve; the balance of the investment pool revenue is distributed to the participating funds. This method is not in accordance with generally accepted accounting principles for the following reasons:

1. The balance in the stabilization reserve may represent undistributed income attributable to both restricted and unrestricted current funds. Thus the balance in the reserve cannot be reported accurately in the financial statements.
2. To the extent any of the undistributed income earned during the fiscal year is attributable to unrestricted current funds, an understatement of revenues of unrestricted current funds will occur.
3. Questions might arise as to the authority of the governing board to withhold amounts of income attributable to, but not distributed to, restricted current funds.

Institutions carrying balances in endowment income stabilization reserves created under this method should dispose of them as appropriate.

The second method, which conforms to generally accepted accounting principles, would distribute *all* income from the pools to the participating funds. The amount applicable to unrestricted current funds would be reported as endowment income. Any amounts set aside for a stabilization reserve should be shown as an allocation of the unrestricted current funds balance and appropriately reflected in the balance sheet as a subdivision of that balance. Amounts applicable to restricted current funds should be reported as an addition to those fund balances. The amounts expended from such balances should be shown as revenues of endowment income in the restricted current funds. Amounts unexpended would remain as balances to be carried forward to the next period.

Sales and Services of Educational Activities

This category includes (1) revenues that are related incidentally to the conduct of instruction, research, and public service and (2) revenues of activities that exist to provide an instructional and laboratory experience for students and that incidentally create goods and services that may be sold to students, faculty, staff, and the general public. The type of service rendered takes precedence over the form of agreement by which these services are rendered. Examples of revenues of educational activities are film rentals, sales of scientific and literary publications, testing services, and sales of products and services of dairy creameries, food technology divisions, poultry farms, and health clinics (apart from student health services) that are not part of a hospital. Revenues generated by hospitals (including health clinics that are a part thereof) should be classified as sales and services of hospitals.

If sales and services to students, faculty, or staff, rather than training or instruction, is the purpose of an activity, the revenue should be classified as sales and services of auxiliary enterprises or hospitals.

Sales and Services of Auxiliary Enterprises

This category includes all revenues generated through operations by auxiliary enterprises. An auxiliary enterprise is an en-

tity that exists to furnish goods or services to students, faculty, or staff, and that charges a fee directly related to, although not necessarily equal to, the cost of the goods or services. The general public incidentally may be served by some auxiliary enterprises.

Auxiliary enterprises usually include residence halls, food services, intercollegiate athletics (if essentially self-supporting), college unions, college stores, and such services as barber shops, beauty parlors, and movie theaters. Even though they may serve students and faculty, hospitals are classified separately because of their size and relative financial importance.

This category is limited to revenues derived directly from the operation of the auxiliary enterprises themselves. Revenues from gifts, grants, or endowment income restricted for auxiliary enterprises should be reported under their respective source categories.

Sales and Services of Hospitals

This category includes revenues (net of discounts, allowances, and provision for doubtful accounts) generated by hospitals from daily patient, special, and other services. Revenues of health clinics that are part of a hospital should be included in this category. Not included are revenues for research and other specific-purpose gifts, grants, or endowment income restricted to the hospital. Such funds should be included in the appropriate revenue sources described above.

Other Sources

This category should include all sources of current funds revenue not included in other classifications. Examples are interest income and gains and losses on investments in current funds, miscellaneous rentals and sales, expired term endowments, and terminated annuity or life income agreements, if not material.

Note: It is appropriate to subtotal all revenues described above; the subtotal excludes revenues of independent operations.

Transfers from Other Funds

Unrestricted amounts transferred from other fund groups back to the Current Funds group are not revenues of the current

funds. An example is the return of quasi-endowment funds from the endowment and similar funds to unrestricted current funds. Such amounts should be identified separately and included in Nonmandatory Transfers (see expenditure categories).

Independent Operations

This category includes all revenues of those operations which are independent of, or unrelated to, but which may enhance the primary missions of the institution—instruction, research, and public service. Included are revenues associated with major federally funded research laboratories and other operations not considered an integral part of the institution's educational, auxiliary enterprise, or hospital activities. This category does not include the net profit (or loss) from operations owned and managed as investments of the institution's endowment funds.

Additions to Fund Balances

The term "additions" is in contrast to revenues and transfers. Additions are amounts received or made available to the restricted current funds during the reporting period as distinguished from the amounts of restricted funds expended during the fiscal period, which are reported as restricted fund revenues.

Current Funds Expenditures and Transfers

Current funds expenditures represent the costs incurred for goods and services used in the conduct of the institution's operations. They include the acquisition cost of capital assets, such as equipment and library books, to the extent current funds are budgeted for and used by operating departments for such purposes. If the amount of ending inventories or the cost of services benefiting subsequent fiscal periods is material (in terms of effect on financial statements), both inventories and deferred charges should be recorded as assets and previously recorded expenditures appropriately decreased. In a subsequent fiscal period these inventories and deferred charges as consumed should be included as expenditures of that period. Significant inventories of materials are usually present in central stores.

A capital asset is defined as any physical resource that benefits a program for more than one year. Capital expenditures therefore include funds expended for land, improvements to land,

buildings, improvements and additions to buildings, equipment, and library books. Most institutional accounting systems provide for recording at least a portion of capital expenditures in the current fund expenditures accounts of the various operating units. Whether an expenditure is to be considered a capital expenditure is generally a matter for institutional determination, or in the case of some public institutions, it is prescribed by state regulation.

The general criteria for defining a capital asset are the relative significance of the amount expended and the useful life of the asset acquired, or in the case of repairs and alterations, the extent to which the useful life is extended. For expenditure reporting purposes, any item costing more than a specific amount, as determined by the institution or appropriate governmental unit, and having an expected useful life of more than one year generally should be classified as a capital expenditure.¹

Interdepartmental transactions ordinarily should be accounted for as an increase in current fund expenditures of the department receiving the materials, services, or capital assets and as a decrease in current fund expenditures of the transferring department. Thus, total institutional expenditures are not inflated by the transactions. Examples are sales and services of service departments and central stores and transfers of material and equipment from one department to another. Any differences between the revenue from sales and services and the operating costs of service departments or central stores, whether debit or credit, are treated as Institutional Support expenditures. On the other hand, sales and services of an auxiliary enterprise to another department or auxiliary enterprise, or sales of materials produced by an instructional department to another department or auxiliary enterprise, would be reported as an expenditure of the department or auxiliary enterprise receiving the materials or services and as revenue of the department or auxiliary enterprise selling the materials or services.

Expenditures differ from transfers. Expenditures are the

¹ The Cost Accounting Standards Board (CASB) has stipulated \$500 and a useful life of more than two years as the threshold at which items must be considered capital assets, and Federal Management Circular 73-8 (formerly OMB Circular A-21) defines equipment as items having an acquisition cost of \$200 or more and an expected service life of one year or more. Different limits which are reasonable and consistently applied are acceptable.

recognition of the expending of resources of the Current Funds group toward the objectives of each of the respective funds of that group. Transfers are amounts moved between fund groups to be used for the objectives of the recipient fund group. There are two types of transfers, mandatory and nonmandatory, which are fully described later in this chapter.

Expenditures and transfers may be classified in a variety of ways to serve a variety of purposes. Some of the factors bearing on the desired classification are :

1. The context in which appropriations, gifts, grants, and other sources of revenue are made to the institution.
2. The mode best suited for preparing and executing the budget.
3. The form that best serves the needs for financial reporting.
4. The presentation that will improve the quality of comparative studies among institutions.

Thus, expenditures and transfers may be classified in terms of programs, functions, organizational units, projects, and object classes.

Classifications by *program* often cut across organizational, functional, and even fund group lines and are useful in the planning processes. The *functional* classification pattern—educational and general, auxiliary enterprises, hospitals, independent operations, and their subcategories—provides the greatest comparability of data among institutions. The classification by *organizational units* provides data corresponding to channels of intra-institutional administrative responsibilities. Classification by *projects* serves to provide data corresponding to the pattern in which gifts, grants, and contracts are utilized by the institution. Classification by *object class*—that is, according to materials or capital assets purchased or services received, such as personal services, staff benefits, printing and stationery, travel, communications, food, fuel, utilities, repairs, equipment, and library books—serves internal management needs.

Published financial reports usually classify expenditures and transfers in terms of function, organizational unit, and object, in that order.

It is suggested that the following functional classification be followed :

- Educational and General
 - Expenditures
 - Instruction
 - Research
 - Public Service
 - Academic Support
 - Student Services
 - Institutional Support
 - Operation and Maintenance of Plant
 - Scholarships and Fellowships
 - Mandatory Transfers
 - Nonmandatory Transfers
- Auxiliary Enterprises
 - Expenditures
 - Mandatory Transfers
 - Nonmandatory Transfers
- Hospitals
 - Expenditures
 - Mandatory Transfers
 - Nonmandatory Transfers
- Independent Operations
 - Expenditures
 - Mandatory Transfers
 - Nonmandatory Transfers

Educational and General

Instruction. This category should include expenditures for all activities that are part of an institution's instruction program, with the exception of expenditures for remedial and tutorial instruction, which should be categorized as Student Services. Expenditures for credit and noncredit courses, for academic, occupational, and vocational instruction, and for regular, special, and extension sessions should be included.

Expenditures for departmental research and public service that are not separately budgeted should be included in this classification. This category excludes expenditures for academic administration when the primary assignment is administration—for example, academic deans. However, expenditures for department chairmen, in which instruction is still an important role of the administrator, are included in this category.

Research. This category should include all expenditures for activities specifically organized to produce research outcomes, whether commissioned by an agency external to the institution or separately budgeted by an organizational unit within the institution. Subject to these conditions, it includes expenditures for individual and/or project research as well as those of institutes and research centers. This category does not include all sponsored programs (training grants are an example) nor is it necessarily limited to sponsored research, since internally supported research programs, if separately budgeted, might be included in this category under the circumstances described above. Expenditures for departmental research that are separately budgeted specifically for research are included in this category.

Public Service. This category should include funds expended for activities that are established primarily to provide noninstructional services beneficial to individuals and groups external to the institution. These activities include community service programs (excluding instructional activities) and cooperative extension services. Included in this category are conferences, institutes, general advisory services, reference bureaus, radio and television, consulting, and similar noninstructional services to particular sectors of the community.

Academic Support. This category should include funds expended primarily to provide support services for the institution's primary missions—instruction, research, and public service. It includes (1) the retention, preservation, and display of educational materials—for example, libraries, museums, and galleries; (2) the provision of services that directly assist the academic functions of the institution, such as demonstration schools associated with a department, school, or college of education; (3) media, such as audiovisual services and technology such as computing support; (4) academic administration (including academic deans but not department chairmen) and personnel development providing administrative support and management direction to the three primary missions; and (5) separately budgeted support for course and curriculum development. For institutions that currently charge certain of the expenditures—for example, computing support—directly to the various operating units of the institution, such expenditures are not reflected in this category.

Student Services. This category should include funds expended

for offices of admissions and registrar and those activities whose primary purpose is to contribute to the student's emotional and physical well-being and to his intellectual, cultural, and social development outside the context of the formal instruction program. It includes expenditures for student activities, cultural events, student newspaper, intramural athletics, student organizations, intercollegiate athletics (if the program is operated as an integral part of the department of physical education and not as an essentially self-supporting activity), supplemental educational services to provide matriculated students with supplemental instruction outside of the normal academic program (remedial instruction is an example), counseling and career guidance (excluding informal academic counseling by the faculty), student aid administration, and student health service (if not operated as an essentially self-supporting activity).

Institutional Support. This category should include expenditures for: (1) central executive-level activities concerned with management and long-range planning of the entire institution, such as the governing board, planning and programming, and legal services; (2) fiscal operations, including the investment office; (3) administrative data processing; (4) space management; (5) employee personnel and records; (6) logistical activities that provide procurement, storerooms, safety, security, printing, and transportation services to the institution; (7) support services to faculty and staff that are not operated as auxiliary enterprises; and (8) activities concerned with community and alumni relations, including development and fund raising.

Appropriate allocations of institutional support should be made to auxiliary enterprises, hospitals, and any other activities not reported under the Educational and General heading of expenditures.

Operation and Maintenance of Plant. This category should include all expenditures of current operating funds for the operation and maintenance of physical plant, in all cases net of amounts charged to auxiliary enterprises, hospitals, and independent operations. It does not include expenditures made from the institutional plant fund accounts. It includes all expenditures for operations established to provide services and maintenance related to grounds and facilities. Also included are utilities, fire protection, property insurance, and similar items.

Scholarships and Fellowships. This category should include expenditures for scholarships and fellowships in the form of outright grants to students selected by the institution and financed from current funds, restricted or unrestricted. It also should include trainee stipends, prizes, and awards, except trainee stipends awarded to individuals who are not enrolled in formal course work, which should be charged to instruction, research, or public service as appropriate. If the institution is given custody of the funds, but is not allowed to select the recipient of the grant—for example, federal Basic Educational Opportunity Grants program or ROTC scholarships—the funds should be reported in the Agency Funds group rather than in the Current Funds group. The recipient of an outright grant is not required to perform service to the institution as consideration for the grant, nor is he expected to repay the amount of the grant to the funding source. When services are required in exchange for financial assistance, as in the federal College Work-Study Program, the charges should be classified as expenditures of the department or organizational unit to which the service is rendered. Aid to students in the form of tuition or fee remissions also should be included in this category. However, remissions of tuition or fees granted because of faculty or staff status, or family relationship of students to faculty or staff, should be recorded as staff benefit expenditures in the appropriate functional expenditure category.

Mandatory Transfers. This category should include transfers from the Current Funds group to other fund groups arising out of (1) binding legal agreements related to the financing of educational plant, such as amounts for debt retirement, interest, and required provisions for renewals and replacements of plant, not financed from other sources, and (2) grant agreements with agencies of the federal government, donors, and other organizations to match gifts and grants to loan and other funds. Mandatory transfers may be required to be made from either unrestricted or restricted current funds.

Nonmandatory Transfers. This category should include those transfers from the Current Funds group to other fund groups made at the discretion of the governing board to serve a variety of objectives, such as additions to loan funds, additions to quasi-endowment funds, general or specific plant additions, voluntary renewals and replacements of plant, and prepayments on debt

principal. It also may include the retransfer of resources back to current funds.

Auxiliary Enterprises

An auxiliary enterprise is an entity that exists to furnish goods or services to students, faculty, or staff, and that charges a fee directly related to, although not necessarily equal to, the cost of the goods or services. The distinguishing characteristic of auxiliary enterprises is that they are managed as essentially self-supporting activities. Examples are residence halls, food services, intercollegiate athletics, (only if essentially self-supporting), college stores, faculty clubs, faculty and staff parking, and faculty housing. Student health services, when operated as an auxiliary enterprise, also should be included. The general public may be served incidentally by auxiliary enterprises. Hospitals, although they may serve students, faculty, or staff, are separately classified because of their relative financial significance.

This category includes all expenditures and transfers relating to the operation of auxiliary enterprises, including expenditures for operation and maintenance of plant and for institutional support; also included are other direct and indirect costs, whether charged directly as expenditures or allocated as a proportionate share of costs of other departments or units.

Expenditures. Expenditures of auxiliary enterprises are identified by using the same general criteria as for educational and general expenditures to distinguish them from transfers.

Mandatory Transfers. This type of transfer follows the same criteria of identification as for educational and general mandatory transfers to distinguish them from expenditures and non-mandatory transfers.

Nonmandatory Transfers. This type of transfer follows the same criteria of identification as for educational and general non-mandatory transfers to distinguish them from expenditures and mandatory transfers.

Hospitals

This category includes all expenditures and transfers associated with the patient care operations of the hospital, including nursing and other professional services, general services, administrative services, fiscal services, and charges for physical plant

operations and institutional support. Also included are other direct and indirect costs, whether charged directly as expenditures or allocated as a proportionate share of costs of other departments or units. Expenditures for those activities which take place within the hospital, but which are categorized more appropriately as instruction or research, should be excluded from this category and accounted for in the appropriate categories.

Expenditures. The same criteria for identifying expenditures are used as in the case of educational and general expenditures to distinguish them from transfers.

Mandatory Transfers. The same criteria for identifying mandatory transfers are used as in the case of educational and general mandatory transfers to distinguish them from expenditures and nonmandatory transfers.

Nonmandatory Transfers. The same criteria for identifying nonmandatory transfers are used as in the case of educational and general nonmandatory transfers to distinguish them from expenditures and mandatory transfers.

Independent Operations

This category includes expenditures and transfers of those operations which are independent of, or unrelated to, but which may enhance the primary missions of the institution. This category generally is limited to expenditures associated with major federally funded research laboratories. This category excludes expenditures associated with property owned and managed as investments of the institution's endowment funds.

Expenditures. The same criteria for identifying expenditures are used as in the case of educational and general expenditures to distinguish them from transfers.

Mandatory Transfers. The same criteria for identifying mandatory transfers are used as in the case of educational and general mandatory transfers to distinguish them from expenditures and nonmandatory transfers.

Nonmandatory Transfers. The same criteria for identifying nonmandatory transfers are used as in the case of educational and general nonmandatory transfers to distinguish them from expenditures and mandatory transfers.

Deductions from Fund Balances

The term “deductions” is in contrast to expenditures and transfers. Deductions represent decreases in current fund balances, such as refunds to donors and grantors, and unencumbered or unexpended funds returned or returnable to the state treasury at fiscal year-end, depending on provisions of state statutes or appropriation acts.

.11 ILLUSTRATIVE EXHIBITS*

[Chapter 5: 7]

THE FIGURES used in the accompanying exhibits are illustrative only and are not intended to indicate any relationship among accounts. The summary of significant accounting policies and notes to financial statements relate to the illustrative statements. Modifications should be made thereto as appropriate to actual circumstances.

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Sample Educational Institution

Balance

June 30,

with comparative figures

Assets**Current Funds**

	Current Year	Prior Year
Unrestricted		
Cash	\$ 210,000	\$ 110,000
Investments	450,000	360,000
Accounts receivable, less allowance of \$18,000 both years.....	228,000	175,000
Inventories, at lower of cost (first-in, first-out basis) or market.....	90,000	80,000
Prepaid expenses and deferred charges	28,000	20,000
Total unrestricted	<u>1,006,000</u>	<u>745,000</u>
Restricted		
Cash	145,000	101,000
Investments	175,000	165,000
Accounts receivable, less allowance of \$8,000 both years	68,000	160,000
Unbilled charges	72,000	—
Total restricted	<u>460,000</u>	<u>426,000</u>
Total current funds.....	<u>1,466,000</u>	<u>1,171,000</u>

Loan Funds

Cash	30,000	20,000
Investments	100,000	100,000
Loans to students, faculty, and staff, less allowance of \$10,000 current year and \$9,000 prior year.....	550,000	382,000
Due from unrestricted funds.....	3,000	—
Total loan funds..	<u>683,000</u>	<u>502,000</u>

Endowment and Similar Funds

Cash	100,000	101,000
Investments	13,900,000	11,800,000

Total endowment and similar funds.... 14,000,000 11,901,000

Exhibit 1

Sheet

19_____

at June 30, 19_____

Liabilities and Fund Balances**Current Funds**

	Current Year	Prior Year
Unrestricted		
Accounts payable	\$ 125,000	\$ 100,000
Accrued liabilities	20,000	15,000
Students' deposits	30,000	35,000
Due to other funds.....	158,000	120,000
Deferred credits	30,000	20,000
Fund balance	<u>643,000</u>	<u>455,000</u>
Total unrestricted	<u>1,006,000</u>	<u>745,000</u>
 Restricted		
Accounts payable	14,000	5,000
Fund balances	<u>446,000</u>	<u>421,000</u>
 Total restricted	<u>460,000</u>	<u>426,000</u>
Total current funds.....	<u>1,466,000</u>	<u>1,171,000</u>

Loan Funds

Fund balances		
U.S. government grants refundable.....	50,000	33,000
University funds		
Restricted	483,000	369,000
Unrestricted	150,000	100,000
Total loan funds.....	<u>683,000</u>	<u>502,000</u>

Endowment and Similar Funds

Fund balances		
Endowment	7,800,000	6,740,000
Term endowment	3,840,000	3,420,000
Quasi-endowment—unrestricted	1,000,000	800,000
Quasi-endowment—restricted	<u>1,360,000</u>	<u>941,000</u>
Total endowment and similar funds ...	<u>14,000,000</u>	<u>11,901,000</u>

Exhibit I—Continued**Annuity and Life Income Funds**

Annuity funds		
Cash	\$ 55,000	\$ 45,000
Investments	3,260,000	3,010,000
Total annuity funds	<u>3,315,000</u>	<u>3,055,000</u>
Life income funds		
Cash	15,000	15,000
Investments	2,045,000	1,740,000
Total life income funds	<u>2,060,000</u>	<u>1,755,000</u>
Total annuity and life income funds ..	<u>5,375,000</u>	<u>4,810,000</u>

Plant Funds

Unexpended		
Cash	275,000	410,000
Investments	1,285,000	1,590,000
Due from unrestricted current funds...	<u>150,000</u>	<u>120,000</u>

Total unexpended	<u>1,710,000</u>	<u>2,120,000</u>
------------------------	------------------	------------------

Renewals and replacements

Cash	5,000	4,000
Investments	150,000	286,000
Deposits with trustees	100,000	90,000
Due from unrestricted current funds	<u>5,000</u>	<u>—</u>
Total renewals and replacements..	<u>260,000</u>	<u>380,000</u>

Retirement of indebtedness

Cash	50,000	40,000
Deposits with trustees.....	250,000	253,000
Total retirement of indebtedness..	<u>300,000</u>	<u>293,000</u>

Investment in plant

Land	500,000	500,000
Land improvements	1,000,000	1,110,000
Buildings	25,000,000	24,060,000
Equipment	15,000,000	14,200,000
Library books	100,000	80,000
Total investment in plant.....	<u>41,600,000</u>	<u>39,950,000</u>
Total plant funds.....	<u>43,870,000</u>	<u>42,743,000</u>

Agency Funds

Cash	50,000	70,000
Investments	60,000	20,000
Total agency funds.....	<u>110,000</u>	<u>90,000</u>

•

See accompanying Summary of Significant Accounting

Annuity and Life Income Funds

Annuity funds		
Annuities payable	\$ 2,150,000	\$ 2,300,000
Fund balances	1,165,000	755,000
Total annuity funds	<u>3,315,000</u>	<u>3,055,000</u>
Life income funds		
Income payable	5,000	5,000
Fund balances	2,055,000	1,750,000
Total life income funds	<u>2,060,000</u>	<u>1,755,000</u>
Total annuity and life income funds....	<u>5,375,000</u>	<u>4,810,000</u>

Plant Funds

Unexpended		
Accounts payable	10,000	—
Notes payable	100,000	—
Bonds payable	400,000	—
Fund balances		
Restricted	1,000,000	1,860,000
Unrestricted	200,000	260,000
Total unexpended	<u>1,710,000</u>	<u>2,120,000</u>

Renewals and replacements

Fund balances		
Restricted	25,000	180,000
Unrestricted	235,000	200,000
Total renewals and replacements..	<u>260,000</u>	<u>380,000</u>

Retirement of indebtedness

Fund balances		
Restricted	185,000	125,000
Unrestricted	115,000	168,000
Total retirement of indebtedness ..	<u>300,000</u>	<u>293,000</u>

Investment in plant

Notes payable	790,000	810,000
Bonds payable	2,200,000	2,400,000
Mortgages payable	400,000	200,000
Net investment in plant.....	<u>38,210,000</u>	<u>36,540,000</u>
Total investment in plant.....	<u>41,600,000</u>	<u>39,950,000</u>
Total plant funds.....	<u>43,870,000</u>	<u>42,743,000</u>

Agency Funds

Deposits held in custody for others.....	110,000	90,000
Total agency funds.....	<u>110,000</u>	<u>90,000</u>

Policies and Notes to Financial Statements

Sample Educational Institution

Statement of Changes in

Year Ended June 30,

	<u>Current Funds</u>	
	<u>Unrestricted</u>	<u>Restricted</u>
Revenues and other additions		
Unrestricted current fund revenues.....	\$7,540,000	
Expired term endowment—restricted		
State appropriations—restricted		
Federal grants and contracts—restricted.....		500,000
Private gifts, grants, and contracts—restricted		370,000
Investment income—restricted		224,000
Realized gains on investments—unrestricted		
Realized gains on investments—restricted.....		
Interest on loans receivable		
U.S. government advances.....		
Expended for plant facilities (including \$100,000 charged to current funds expenditures).....		
Retirement of indebtedness		
Accrued interest on sale of bonds.....		
Matured annuity and life income restricted to endowment		
Total revenues and other additions.....	<u>7,540,000</u>	<u>1,094,000</u>
Expenditures and other deductions		
Educational and general expenditures.....	4,400,000	1,014,000
Auxiliary enterprises expenditures.....	1,830,000	
Indirect costs recovered		35,000
Refunded to grantors.....		20,000
Loan cancellations and write-offs		
Administrative and collection costs		
Adjustment of actuarial liability for annuities payable.....		
Expended for plant facilities (including noncapitalized expenditures of \$50,000)		
Retirement of indebtedness		
Interest on indebtedness		
Disposal of plant facilities		
Expired term endowments (\$40,000 unrestricted, \$50,000 restricted to plant)		
Matured annuity and life income funds restricted to endowment....		
Total expenditures and other deductions.....	<u>6,230,000</u>	<u>1,069,000</u>

Exhibit 2

Fund Balances

19_____

Loan Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Plant Funds			
			Unex- pended	Renewals and Replace- ments	Retire- ment of Indebt- edness	Investment in Plant
			50,000			
			50,000			
100,000	1,500,000	800,000	115,000		65,000	15,000
12,000	10,000		5,000	5,000	5,000	
	109,000					
4,000	50,000		10,000	5,000	5,000	
7,000						
18,000						
						1,550,000
						220,000
					3,000	
	10,000					
<u>141,000</u>	<u>1,679,000</u>	<u>800,000</u>	<u>230,000</u>	<u>10,000</u>	<u>78,000</u>	<u>1,785,000</u>
10,000						
1,000						
1,000					1,000	
		75,000				
			1,200,000	300,000		
					220,000	
					190,000	
						115,000
	90,000					
		10,000				
<u>12,000</u>	<u>90,000</u>	<u>85,000</u>	<u>1,200,000</u>	<u>300,000</u>	<u>411,000</u>	<u>115,000</u>

Exhibit 2—Continued

Transfers among funds—additions/(deductions)	Current Funds	
	Unrestricted	Restricted
Mandatory:		
Principal and interest.....	(340,000)	
Renewals and replacements.....	(170,000)	
Loan fund matching grant.....	(2,000)	
Unrestricted gifts allocated.....	(650,000)	
Portion of unrestricted quasi-endowment funds investment gains appropriated.....	40,000	
Total transfers.....	(1,122,000)	
Net increase/(decrease) for the year.....	188,000	25,000
Fund balance at beginning of year.....	455,000	421,000
Fund balance at end of year.....	643,000	446,000

See accompanying Summary of Significant Accounting

<u>Loan Funds</u>	<u>Endowment and Similar Funds</u>	<u>Annuity and Life Income Funds</u>	<u>Plant Funds</u>			
			<u>Unex- pended</u>	<u>Renewals and Replace- ments</u>	<u>Retire- ment of Indebt- edness</u>	<u>Investment in Plant</u>
					340,000	
				170,000		
2,000						
50,000	550,000		50,000			
	(40,000)					
<u>52,000</u>	<u>510,000</u>		<u>50,000</u>	<u>170,000</u>	<u>340,000</u>	
181,000	2,099,000	715,000	(920,000)	(120,000)	7,000	1,670,000
<u>502,000</u>	<u>11,901,000</u>	<u>2,505,000</u>	<u>2,120,000</u>	<u>380,000</u>	<u>293,000</u>	<u>36,540,000</u>
<u>683,000</u>	<u>14,000,000</u>	<u>3,220,000</u>	<u>1,200,000</u>	<u>260,000</u>	<u>300,000</u>	<u>38,210,000</u>

Policies and Notes to Financial Statements

Sample Educational Institution

Statement of Current Funds Revenues,

Year Ended June

Revenues

Tuition and fees	
Federal appropriations	
State appropriations	
Local appropriations	
Federal grants and contracts	
State grants and contracts	
Local grants and contracts	
Private gifts, grants, and contracts	
Endowment income	
Sales and services of educational departments	
Sales and services of auxiliary enterprises	
Expired term endowment	
Other sources (if any)	
Total current revenues	

Expenditures and mandatory transfers

Educational and general	
Instruction	
Research	
Public service	
Academic support	
Student services	
Institutional support	
Operation and maintenance of plant	
Scholarships and fellowships	
Educational and general expenditures	
Mandatory transfers for:	
Principal and interest	
Renewals and replacements	
Loan fund matching grant	
Total educational and general	

Exhibit 3

Expenditures, and Other Changes

30, 19____

<u>Unrestricted</u>	<u>Current Year</u>		<u>Prior Year Total</u>
	<u>Restricted</u>	<u>Total</u>	
\$2,600,000		\$2,600,000	\$2,300,000
500,000		500,000	500,000
700,000		700,000	700,000
100,000		100,000	100,000
20,000	\$ 375,000	395,000	350,000
10,000	25,000	35,000	200,000
5,000	25,000	30,000	45,000
850,000	380,000	1,230,000	1,190,000
325,000	209,000	534,000	500,000
190,000		190,000	195,000
2,200,000		2,200,000	2,100,000
40,000		40,000	
<u>7,540,000</u>	<u>1,014,000</u>	<u>8,554,000</u>	<u>8,180,000</u>
2,960,000	489,000	3,449,000	3,300,000
100,000	400,000	500,000	650,000
130,000	25,000	155,000	175,000
250,000		250,000	225,000
200,000		200,000	195,000
450,000		450,000	445,000
220,000		220,000	200,000
90,000	100,000	190,000	180,000
<u>4,400,000</u>	<u>1,014,000</u>	<u>5,414,000</u>	<u>5,370,000</u>
90,000		90,000	50,000
100,000		100,000	80,000
2,000		2,000	
<u>4,592,000</u>	<u>1,014,000</u>	<u>5,606,000</u>	<u>5,500,000</u>

Exhibit 3—Continued

Expenditures and mandatory transfers

Auxiliary enterprises	
Expenditures	
Mandatory transfers for:	
Principal and interest.....	
Renewals and replacements.....	
Total auxiliary enterprises.....	
Total expenditures and mandatory transfers	

Other transfers and additions/(deductions)

Excess of restricted receipts over transfers to revenues.....	
Refunded to grantors.....	
Unrestricted gifts allocated to other funds.....	
Portion of quasi-endowment gains appropriated	
Net increase in fund balances.....	

See accompanying Summary of Significant

<u>Unrestricted</u>	<u>Current Year</u>		<u>Prior Year Total</u>
	<u>Restricted</u>	<u>Total</u>	
1,830,000		1,830,000	1,730,000
250,000		250,000	250,000
70,000		70,000	70,000
<u>2,150,000</u>		<u>2,150,000</u>	<u>2,050,000</u>
<u>6,742,000</u>	<u>1,014,000</u>	<u>7,756,000</u>	<u>7,550,000</u>
	45,000	45,000	40,000
	(20,000)	(20,000)	
(650,000)		(650,000)	(510,000)
<u>40,000</u>		<u>40,000</u>	
<u>188,000</u>	<u>25,000</u>	<u>213,000</u>	<u>160,000</u>

Accounting Policies and Notes to Financial Statements

SAMPLE EDUCATIONAL INSTITUTION SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

June 30, 19——

The significant accounting policies followed by Sample Educational Institution are described below to enhance the usefulness of the financial statements to the reader.

Accrual Basis

The financial statements of Sample Educational Institution have been prepared on the accrual basis except for depreciation accounting as explained in notes 1 and 2 to the financial statements. The statement of current funds revenues, expenditures, and other changes is a statement of financial activities of current funds related to the current reporting period. It does not purport to present the results of operations or the net income or loss for the period as would a statement of income or a statement of revenues and expenses.

To the extent that current funds are used to finance plant assets, the amounts so provided are accounted for as (1) expenditures, in the case of normal replacement of movable equipment and library books; (2) mandatory transfers, in the case of required provisions for debt amortization and interest and equipment renewal and replacement; and (3) transfers of a nonmandatory nature for all other cases.

Fund Accounting

In order to ensure observance of limitations and restrictions placed on the use of the resources available to the Institution, the accounts of the Institution are maintained in accordance with the principles of "fund accounting." This is the procedure by which resources for various purposes are classified for accounting and reporting purposes into funds that are in accordance with activities or objectives specified. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds that have similar characteristics have been combined into fund groups. Accordingly, all financial transactions have been recorded and reported by fund group.

Within each fund group, fund balances restricted by outside sources are so indicated and are distinguished from unrestricted funds allocated to specific purposes by action of the governing board. Externally restricted funds may only be utilized in accordance with the purposes established by the source of such funds and are in contrast with unrestricted funds over which the governing board retains full control to use in achieving any of its institutional purposes.

Endowment funds are subject to the restrictions of gift instruments requiring in perpetuity that the principal be invested and the income only be utilized. Term endowment funds are similar to endowment funds except that upon the passage of a stated period of time or the occurrence of a particular event, all or part of the principal may be expended. While quasi-endowment funds have been established by the governing board for the same purposes as endowment funds, any portion of quasi-endowment funds may be expended.

All gains and losses arising from the sale, collection, or other disposition of investments and other noncash assets are accounted for in the fund which owned such assets. Ordinary income derived from investments, receivables, and the like is accounted for in the fund owning such assets, except for income derived from investments of endowment and similar funds, which income is accounted for in the fund to which it is restricted or, if unrestricted, as revenues in unrestricted current funds.

All other unrestricted revenue is accounted for in the unrestricted current fund. Restricted gifts, grants, appropriations, endowment income, and other restricted resources are accounted for in the appropriate restricted funds. Restricted current funds are reported as revenues and expenditures when expended for current operating purposes.

Other Significant Accounting Policies

Other significant accounting policies are set forth in the financial statements and the notes thereto.

SAMPLE EDUCATIONAL INSTITUTION NOTES TO FINANCIAL STATEMENTS

June 30, 19——

1. Investments exclusive of physical plant are recorded at

cost; investments received by gifts are carried at market value at the date of acquisition. Quoted market values of investments (all marketable securities) of the funds indicated were as follows:

	<u>Current year</u>	<u>Prior year</u>
Unrestricted current funds	\$ 510,000	\$ 390,000
Restricted current funds	180,000	165,000
Loan funds	105,000	105,000
Unexpended plant funds	1,287,000	1,600,000
Renewal and replacement funds .	145,000	285,000
Agency funds	60,000	20,000

Investments of endowment and similar funds and annuity and life income funds are composed of the following:

	<u>Carrying value Current year</u>	<u>Prior year</u>
Endowment and similar funds:		
Corporate stocks and bonds (approximate market, current year \$15,000,000, prior year \$10,900,000)	\$13,000,000	\$10,901,000
Rental properties—less accumulated depreciation, current year \$500,000, prior year \$400,000	900,000	899,000
	<u>13,900,000</u>	<u>11,800,000</u>
Annuity funds:		
U.S. bonds (approximate market, current year \$200,000, prior year \$100,000)	200,000	110,000
Corporate stocks and bonds (approximate market, current year \$3,070,000, prior year \$2,905,000)	3,060,000	2,900,000
	<u>3,260,000</u>	<u>3,010,000</u>
Life income funds:		
Municipal bonds (approximate market, current year \$1,400,000, prior year \$1,340,000)	1,500,000	1,300,000

Corporate stocks and bonds
(approximate market,
current year \$650,000, prior
year \$400,000)

545,000	440,000
<u>2,045,000</u>	<u>1,740,000</u>

Assets of endowment funds, except nonmarketable investments of term endowment having a book value of \$200,000 and quasi-endowment having a book value of \$800,000, are pooled on a market value basis, with each individual fund subscribing to or disposing of units on the basis of the value per unit at market value at the beginning of the calendar quarter within which the transaction takes place. Of the total units each having a market value of \$15.00, 600,000 units were owned by endowment, 280,000 units by term endowment, and 120,000 units by quasi-endowment at June 30, 19——

The following tabulation summarizes changes in relationships between cost and market values of the pooled assets:

	<i>Pooled Assets</i>		<i>Net Gains (Losses)</i>	<i>Market Value per Unit</i>
	<i>Market</i>	<i>Cost</i>		
End of year ..	\$15,000,000	\$13,000,000	\$2,000,000	\$15.00
Beginning				
of year	10,900,000	10,901,000	<u>(1,000)</u>	12.70
Unrealized				
net gains				
for year ...			2,001,000	
Realized				
net gains				
for year ...			<u>159,000</u>	
Total				
net gains				
for year ...			<u>\$2,160,000</u>	<u>2.30</u>

The average annual earnings per unit, exclusive of net gains, were \$.56 for the year.

2. Physical plant and equipment are stated at cost at date of acquisition or fair value at date of donation in the case of gifts, except land acquired prior to 1940, which is valued at appraisal value in 1940 at \$300,000. Depreciation on physical plant and equipment is not recorded.

3. Long-term debt includes: bonds payable due in annual installments varying from \$45,000 to \$55,000 with interest at $5\frac{7}{8}\%$, the final installment being due in 19...., collateralized by trust indenture covering land, buildings, and equipment known as Smith dormitory carried in the accounts at \$2,500,000, and pledged net revenue from the operations of said dormitory; and mortgages payable due in varying amounts to 19.... with interest at 6%, collateralized by property carried in the accounts at \$800,000 and pledged revenue of the Student Union amounting to approximately \$65,000 per year.

4. The Institution has certain contributory pension plans for academic and nonacademic personnel. Total pension expense for the year was \$350,000, which includes amortization of prior service cost over a period of 20 years. The Institution's policy is to fund pension costs accrued, including periodic funding of prior years' accruals not previously funded. The actuarially computed value of vested benefits as of June 30, 19..... exceeded net assets of the pension fund by approximately \$300,000.

5. Contracts have been let for the construction of additional classroom buildings in the amount of \$3,000,000. Construction and equipment are estimated to aggregate \$5,000,000, which will be financed by available resources and an issue of bonds payable over a period of 40 years amounting to \$4,000,000.

6. All interfund borrowings have been made from unrestricted funds. The amounts due to plant funds from current unrestricted funds are payable within one year without interest. The amount due to loan funds from current unrestricted funds is payable currently.

7. Pledges totaling \$260,000, restricted to plant fund uses, are due to be collected over the next three fiscal years in the amounts of \$120,000, \$80,000, and \$60,000, respectively. It is not practicable to estimate the net realizable value of such pledges.

CHART OF ACCOUNTS*

[Chapter 5: 6]

A SYSTEMATIC CLASSIFICATION of accounts is an essential part of an accounting system. The accounts should be developed to be compatible with the organizational structure of the institution, and their form and content should be arranged in agreement with the financial reports to be presented.

The arrangement should be formalized in a chart of accounts, and for ease of identification and reference, each account should be assigned an appropriate code number or symbol. Classification should be according to the funds and fund groups of the institution, as described in the preceding chapters of Part 5. Within each fund group, the accounts should be listed according to assets, liabilities, and fund balance accounts.

The illustrative chart of accounts for a college or university presented below shows those accounts usually found in the general ledger or carried in subsidiary ledgers with appropriate control accounts in the general ledger. This chart is presented as a guide for institutions in developing their own detailed charts of accounts and to help them set up their accounts in conformity with the principles of accounting and reporting presented in the preceding chapters of Part 5. The system of accounts may be expanded, contracted, or modified to meet the needs of the individual institution and to conform to its organizational structure, but in any case it should incorporate the basic elements common to all educational institutions.

In designing or revising a chart of accounts, the code numbers or symbols assigned to the accounts should progress in a logical order. Because each fund and fund group is carried in the accounting records as a separately balanced group, the accounts in any given group should be assigned a code number that, perhaps by a prefix, identifies that fund group—for example, all accounts related to current funds should be identifiable as such; all accounts for plant funds should be identifiable as such. Similarly, within the fund groups, consistent code numbers should identify subgroups, assets, liabilities, and fund balances. For revenue accounts, code numbers or symbols can be used to identify sources.

* From *College and University Business Administration*, third edition (Washington, D.C., 1974), by permission of the National Association of College and University Business Officers.

For expenditure accounts, code numbers or symbols can be used to identify functions, organizational units, projects, programs, and objects of expenditures. The individual fund identity should be an integral part of the fund balance, revenue, and expenditure account codes.

In developing a chart of accounts, it is important to exercise economy in the use of digits and characters for code numbers, to plan a logical arrangement for the chart, and to make ample provision for future expansion of account numbers.

GENERAL LEDGER ACCOUNTS

Current Funds—Unrestricted

Asset Accounts

Cash

Petty Cash

Investments

Accounts Receivable—*detailed as needed, for example:*

Students

Hospital Patients

Governmental

Unbilled Charges

Notes Receivable—*detailed as needed*

Allowance for Doubtful Accounts and Notes—*credit balance account associated with each type of receivable*

Inventories—*detailed as needed, for example:*

College Store

Dining Halls

Central Stores

Plant Operation and Maintenance Supply Store

Prepaid Items and Deferred Charges—*detailed as needed*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Notes Payable

Accounts Payable and Accrued Expenses—*detailed as needed*

Deferred Credits

Deposits

Due to Other Fund Groups

Fund Balances—Allocated—*detailed as needed, for example:*

Auxiliary Enterprises

Reserve for Encumbrances

Reserve for Computer Use Survey

Reserve for Faculty Self-Improvement Program

Fund Balance—Unallocated

Operating Accounts. The following control accounts in the general ledger for actual revenues, expenditures, and other changes are supported in detail by Current Funds Revenues and Current Funds Expenditures

and Other Changes accounts in subsidiary ledgers. If desired, several control accounts may be provided in lieu of single control accounts:

Revenues Control—*credit account*

Expenditures and Other Changes Control—*debit account*

When budgetary accounts are carried in the general ledger, the following control accounts would appear in the chart of accounts. They are supported in detail by Current Funds Revenues and Current Funds Expenditures and Other Changes accounts in subsidiary ledgers:

Estimated Revenues or Unrealized Revenues

Expenditures and Other Changes Allocations or Budget Allocations for Expenditures and Other Changes

Unallocated Budget Balance or Unassigned Budget Balance

Current Funds—Restricted

These accounts are to be used if the assets and liabilities of such funds are separated from those of Unrestricted Current Funds.

Asset Accounts

Cash

Investments

Accounts Receivable—*detailed as needed, for example:*

Governmental

Other

Unbilled Charges

Allowance for Doubtful Accounts—*credit balance account*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Due to Other Fund Groups

Fund Balances—Allocated—*detailed as needed, for example:*

Reserve for Encumbrances

Auxiliary Enterprises

Fund Balances—Unallocated

Both of the fund balance accounts may be control accounts supported by separate subsidiary ledger accounts for each restricted current fund and for each type of fund balance. Additional control accounts may be provided as required or desired.

Operating Accounts. Expenditures of restricted current funds may be recorded in the operating accounts of unrestricted current funds, in which case transfers of restricted current funds to current funds revenues accounts would be made to finance such expenditures. When this is not done, operating accounts for each current restricted fund must provide for proper classification of expenditures by object, as well as providing for appropriate categorization of sources of additions, deductions other than expenditures, and transfers to and from other funds.

Loan Funds

Asset Accounts

- Cash
- Investments
- Notes Receivable from Students, Faculty, and Staff
- Allowance for Doubtful Loans—*credit balance account*

Liability and Fund Balance Accounts

- Accounts Payable to Collection Agencies
- Due to Other Fund Groups
- Refunds Payable on Refundable Government Grants
- Fund Balances—*This may be a control account supported by separate subsidiary ledger accounts for each fund. Separate accounts should be carried to identify the sources of funds available for loans, such as donor- and government-restricted loan funds, including funds provided by mandatory transfers required for matching purposes, unrestricted funds designated as loan funds, and funds returnable to the donor under certain conditions. Accounts to identify allocations of fund balances should be provided. Accounts may be maintained to identify resources available for loans to students separately from those for faculty and staff.*

Endowment and Similar Funds

Asset Accounts

- Cash
- Accounts Receivable
- Notes Receivable
- Allowance for Doubtful Accounts and Notes—*credit balance account*
- Prepaid Items
- Investments—*detailed as needed, for example:*
 - Bonds
 - Allowance for Unamortized Bond Premiums
 - Allowance for Unamortized Bond Discounts
 - Preferred Stocks
 - Common Stocks
 - Mortgage Notes
 - Real Estate
 - Allowance for Depreciation—*credit balance account*
- Due from Other Fund Groups

Liability and Fund Balance Accounts

- The fund balance accounts should be classified as to Endowment, Term Endowment, and Quasi-Endowment Funds, even though the investments of the funds may be merged in one or more investment pools.*
- Payables—*detailed as needed, for example:*
 - Mortgages Payable
 - Notes Payable
 - Accounts Payable
 - Collateral Due on Securities Loaned
 - Due to Other Fund Groups

Balances of Endowment Funds

Balances of Term Endowment Funds

Balances of Quasi-Endowment Funds—Unrestricted

Balances of Quasi-Endowment Funds—Restricted

In order to differentiate between the balances of funds for which the income is unrestricted and those for which the income is restricted, the following accounts may be employed:

Balances of Endowment Funds—Unrestricted

Balances of Endowment Funds—Restricted—*detailed as needed, for example:*

Professorships

Instructional Departments

Scholarships

Library

Loan Funds

Note. The balances of term endowment funds also may be identified in this manner.

Undistributed Gains and Losses on Investment Transactions—*Separate accounts should be established for each investment pool.*

Undistributed Share Adjustments—*Separate accounts should be established for each investment pool.*

Annuity and Life Income Funds

If the funds in this section are pooled for investment purposes, accounts for the assets may be classified as shown below for each investment pool. If any funds are separately invested, accounts should be set up for the investment of such funds.

Asset Accounts

Cash

Accounts Receivable

Notes Receivable

Allowance for Doubtful Accounts and Notes—*credit balance account*

Investments—*detailed as needed, for example:*

Bonds

Allowance for Unamortized Bond Premiums

Allowance for Unamortized Bond Discounts

Preferred Stocks

Common Stocks

Mortgage Notes

Real Estate

Allowance for Depreciation—*credit balance account*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Annuity Payments Currently Due

Annuities Payable

Life Income Payments Currently Due

Due to Other Funds for Advances on Annuity Payments

Due to Other Funds for Advances to Income Beneficiaries

Undistributed Income—Annuity Funds

Undistributed Income—Life Income Funds

Balances of Annuity Funds

Balances of Life Income Funds

These may be control accounts supported by subsidiary ledger accounts for each fund. Within the two categories the accounts may be listed alphabetically by name, or they may be classified in any other manner at the discretion of the institution.

Undistributed Gains and Losses on Investment Transactions—*Separate accounts should be established for each investment pool.*

Undistributed Share Adjustments—*Separate accounts should be established for each investment pool.*

Income, Expenditure, and Transfer Accounts

Income from Investments—*credit account, detailed by each agreement*

Expenditures and Transfers—*debit account, detailed by each agreement*

Plant Funds—Unexpended

Asset Accounts

Cash

Investments

Receivables—*detailed as needed*

Allowance for Doubtful Accounts—*credit balance account*

Due from Other Fund Groups

Construction in Progress—*alternatively can be shown in Investment in Plant subgroup of Plant Funds*

Liability and Fund Balance Accounts

Accounts Payable

Notes Payable

Bonds Payable

Mortgages Payable

Due to Other Fund Groups

Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Funds for Renewals and Replacements

These accounts should be used if the assets of such funds are separated from the assets of other subgroups of Plant Funds.

Asset Accounts

Cash

Accounts Receivable

Allowance for Doubtful Accounts—*credit balance account*

Investments

Deposits with Trustees

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Due to Other Fund Groups

Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.***Plant Funds—Funds for Retirement of Indebtedness***These accounts should be used if the assets of such funds are separated from the assets of other subgroups of Plant Funds.***Asset Accounts**

Cash

Accounts and Notes Receivable

Allowance for Doubtful Accounts—*credit balance account*

Investments

Deposits with Trustees

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Due to Other Fund Groups

Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.***Plant Funds—Investment in Plant****Asset Accounts**

Land

Buildings

Allowance for Depreciation—*credit balance account*

Improvements Other than Buildings

Allowance for Depreciation—*credit balance account*

Equipment

Allowance for Depreciation—*credit balance account*

Library Books

Art Museums and Collections

Construction in Progress—*alternatively can be shown in the Unexpended Plant Funds subgroup of Plant Funds***Liability and Fund Balance Accounts**

Accounts Payable

Notes Payable

Bonds Payable

Mortgages Payable

Leaseholds Payable

Due to Other Fund Groups

Net Investment in Plant —*detailed as needed*

Agency Funds**Asset Accounts**

Cash

Accounts Receivable

Notes Receivable

Allowance for Doubtful Accounts and Notes—*credit balance account*

Investments

Due from Other Fund Groups

Liability Accounts

Accounts Payable

Due to Other Fund Groups

Deposit Liabilities—*Accounts for each agency fund should be carried either in the general ledger or in subsidiary ledgers.***CURRENT FUNDS REVENUES ACCOUNTS****(Separate Restricted and Unrestricted Accounts)****Tuition and Fees**—*detailed as needed***Federal Appropriations****State Appropriations****Local Appropriations****Federal Grants and Contracts****State Grants and Contracts****Local Grants and Contracts****Private Gifts, Grants, and Contracts**—*detailed as needed***Endowment Income**—*detailed as needed, for example:*

Income from Funds Held by Others Under Irrevocable Trusts

Sales and Services of Educational Activities—*detailed as needed, for example:*

Film Rentals

Testing Services

Home Economics Cafeteria

Demonstration Schools

Dairy Creameries

Food Technology Divisions

Sales and Services of Auxiliary Enterprises—*detailed as needed, for example:*

Residence Halls
Faculty Housing
Food Services
College Union

Additional revenue accounts may be established for sources of sales, types of products and services, and cash and interdepartmental sales.

Sales and Services of Hospitals—*detailed as needed, for example:*

Daily Patient Services
Nursing Services
Other Professional Services
Health Clinics *if an integral part of the hospital*

Other Sources—*detailed as needed*

Independent Operations—*detailed as needed by organizational units*

CURRENT FUNDS EXPENDITURES AND TRANSFERS ACCOUNTS

Current funds expenditures accounts should bear identifying codes and symbols that will identify functions, such as Instruction, Institutional Support, and Scholarships and Fellowships; identify organizational units, such as Department of Physics, Controller's Office, and Registrar's Office; and identify the object of expenditures, such as Personnel Compensation, Supplies and Expenses, and Capital Expenditures. If desired, interdepartmental purchases, as contrasted with purchases from external sources, also may be identified by code or symbol. The object coding and symbols should be designed to provide for common usage of the objects throughout the entire chart of accounts, although, of course, there will be individual object codings that will be used only for particular functional categories.

Educational and General

Instruction

Accounts by divisions, schools, colleges, and departments of instruction following the administrative organization of the institution. The four functional subcategories are:

General academic instruction
Occupational and vocational instruction
Special session instruction
Community education

Research

Accounts by individual projects, classified by organizational units. The two functional subcategories are:

- Institutes and research centers
- Individual or project research

Public Service

Accounts by activities, classified by type of activity, such as:

- Community Service
- Conferences and Institutes
- Cooperative Extension Service
- Public Lectures
- Radio
- Television

Academic Support

Accounts by activities, classified by type of activity, such as:

- Academic Administration and Personnel Development
- Audiovisual Services
- Computing Support (*excluding administrative data processing*), *unless distributed to using activities*
- Course and Curriculum Development
- Demonstration Schools
- Libraries
- Museums and Galleries

Student Services

Accounts by activities, classified by type of activity, such as:

- Admissions Office
- Counseling and Career Guidance
- Cultural Events
- Dean of Students
- Financial Aid Administration
- Health and Infirmary Services *if not an integral part of a hospital nor operated as an essentially self-supporting operation*
- Intramural Athletics
- Intercollegiate Athletics *if operated as an integral part of department of physical education and not essentially self-supporting*
- Registrar
- Student Organizations
- Remedial Instruction

Institutional Support—*detailed as needed, for example:*

- Governing Board
- Chief Executive Office
- Chief Academic Office
- Chief Business Office
- Investment Office
- Legal Counsel
- Administrative Data Processing

Alumni Office
 Auditing, internal and external
 Safety
 Security
 Catalogues and Bulletins
 Commencements
 Convocations
 Development Office
 Employee Personnel and Records
 Fund Raising
 General Insurance *other than Property Insurance*
 Interest on Current Funds Loans
 Legal Fees
 Memberships
 Printing
 Provisions for Doubtful Accounts and Notes
 Publications
 Public Relations
 Purchasing
 Service Departments

There should be interim accounts for all organizational units classified in this category; these accounts should be closed out at the end of each fiscal year.

Space Management

Telephone and Telegraph *unless charged to departmental budgets*
 Transportation *including motor pool, unless operated as a service department*

Operation and Maintenance of Plant

Accounts for all organizational units and functions, such as:

Administration
 Custodial Services
 Maintenance of Buildings
 Maintenance of Grounds
 Utilities
 Trucking Services
 Fire Protection
 Property Insurance

Scholarships and Fellowships

Accounts as needed and desired for scholarships, fellowships, grants-in-aid, trainee stipends, prizes, and awards.

Tuition and Fee Remissions unless properly classified as staff benefit expenditures

Accounts may be set up for instructional divisions and departments, such as:

School of Medicine
 Department of Physics

Mandatory Transfers, Educational and General—*detailed to show subcategories, such as:*

Provision for Debt Service on Educational Plant
Loan Fund Matching Grants

Nonmandatory Transfers, Educational and General (*to and from*)
—*detailed to show significant subcategories, such as:*

Loan Funds
Quasi-Endowment Funds
Appreciation on Securities of Endowment and Similar Funds
Plant Funds
Renewals and Replacements of Plant Assets
Additions to Plant Assets
Voluntary Payments on Debt Principal

Auxiliary Enterprises, Hospitals, and Independent Operations

Auxiliary Enterprises

Accounts as needed and desired for such enterprises as included in the Current Funds Revenues accounts.

Provision should be made for identification of mandatory and non-mandatory transfers—to and from—by significant subcategories.

Hospitals

Accounts as needed and desired. Provision should be made for identification of mandatory and nonmandatory transfers—to and from—by significant subcategories.

Independent Operations

Accounts as needed and desired for organizational units.

Provision should be made for identification of mandatory and non-mandatory transfers—to and from—by significant subcategories.

CLASSIFICATION OF EXPENDITURES BY OBJECT

The object classification of expenditures identifies that which is received in return for the expenditures. Object classification has importance as a tool for internal management, but should be considered complementary to the classification of expenditures by function and organizational unit and should not replace these classifications in the various schedules of current funds expenditures. The value of object classification will depend on the usefulness of the information it provides to management. The classifications may be omitted from published financial reports or they may be used to any degree considered desirable by the institution. The use of object classifications and the related identifying codes

and symbols should not be carried to an extreme; the number of categories should be limited to those that will be of significant value to management.

Three major object classifications are found in most colleges and universities: Personnel Compensation, Supplies and Expenses, and Capital Expenditures. Breakdowns of objects within these major categories may be necessary or desirable in some situations.

Personnel Compensation

This classification includes salaries, wages, and staff benefits. In the various salary and wage expense accounts, it may be desirable to distinguish between groups of faculty and other staff members, such as full-time and part-time personnel; student and nonstudent workers; and professional, secretarial, clerical, skilled, and nonskilled employees. Appropriate code numbers and symbols within this category will aid in identifying, collecting, and summarizing information.

Supplies and Expenses

Because of their general significance to nearly all organizational units within an institution, it may be beneficial to identify significant categories of these expenditures, such as supplies, telephones, travel, and contractual services.

Capital Expenditures

The following object categories within this classification (which includes both additions to and renewals and replacements of capital assets) may prove helpful in the accounting and reporting systems of educational institutions: scientific equipment, laboratory apparatus, office machines and equipment, library books, furniture and furnishings, motor vehicles, machinery and tools, building remodeling, minor construction, and livestock.

►→ *The next page is 17,151.* ←◄

Section 10,030

Statement of Position 74-11 Financial Accounting and Reporting by Face-Amount Certificate Companies

**[Proposal to Financial Accounting Standards Board to Amend
AICPA Industry Audit Guide on Audits of Investment Companies with
Respect to Face-Amount Certificate Companies]**

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 10, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Proposal to Amend
AICPA Industry Audit Guide on
Audits of Investment Companies
With Respect to
Face-Amount Certificate Companies

Dear Mr. Armstrong:

The accompanying Statement of Position, prepared by the Accounting Standards Task Force on Investment Companies, proposes amendments to the AICPA Industry Audit Guide on Audits of Investment Companies which would exclude face-amount certificate companies from the general definition of investment companies set forth in the Guide. Accordingly, these companies (there are four in active operation at the present time) would not be required to follow the accounting provisions of the Guide.

While issuance of this Statement of Position will be helpful to independent auditors, we urge that FASB advise the accounting profession at an early date as to whether it believes the proposed amendments are appropriate and should be regarded as having the same authoritative support as the Audit Guide itself.

Members of the Task Force will be glad to meet with you or your representatives to discuss this proposal. The Task Force would also appreciate being advised as to the Board's proposed action on its recommendations.

Sincerely yours,

ACCOUNTING STANDARDS TASK FORCE ON INVESTMENT COMPANIES

James H. Muller, Chairman
Charles Adams
Philip L. Cohen
S. Leland Dill
Robert J. Gummer

Edwin N. Hanlon
William T. Kennedy
David A. O'Keefe
Frederick M. Werblow
John Woodcock, Jr.

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NOTES

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 these Guides, AICPA Task Forces 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 Task Force.

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 such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force 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 Task Force believes would be in the public interest.

FINANCIAL ACCOUNTING AND REPORTING BY FACE-AMOUNT CERTIFICATE COMPANIES

BACKGROUND INFORMATION

.01 The AICPA Industry Audit Guide sets forth the following general definition of the investment company industry:

"The business of an investment company consists of selling its capital shares to the public, investing the proceeds—for the most part in securities—in a manner seeking to achieve its announced investment objectives, and distributing to its shareholders the net income from, and the net gains realized on sales of, its investments. Generally, an investment company can be said to be a pooling of funds by shareholders to avail themselves of professional investment management."¹

¹ AICPA, *Audits of Investment Companies*, (New York: 1973), p. 1.

.02 The Guide then includes face-amount certificate companies as investment companies to which the Guide is applicable by the following:

“Within the umbrella of the above general definition fall many forms of investment companies, including management investment companies, *face-amount certificate companies* (emphasis supplied), unit investment trusts, collective trust funds, investment partnerships, and ‘offshore funds’.”²

.03 In its Glossary, the Guide defines a face-amount certificate as “A security representing an obligation of the issuer to pay a stated amount at a fixed date in the future, the consideration for which is either payment of periodic installments of a stated amount or a single lump payment.” A face-amount certificate company is “An investment company engaged in the business of issuing face-amount certificates of the installment type.”³

.04 The task force has reconsidered the appropriateness of including face-amount certificate companies in the definition of “investment companies” included in the Guide.

RECOMMENDATION

.05 The Task Force believes that face-amount certificate companies do not fall within the general definition of investment companies set forth in the Guide and, therefore, such companies should not be required to follow the accounting provisions of the Guide.

.06 Specifically, the Task Force believes that *Audits of Investment Companies* should be amended as follows:

- (a) The phrase “face-amount certificate companies,” should be deleted from the first sentence of the second paragraph on page 1 of the Guide.
- (b) The definition of a face-amount certificate company on page 141 of the Guide should be changed to read, “A company (not an “investment company” as defined elsewhere herein, but subject to the provisions of the Investment Company Act of 1940) engaged in the business of issuing face-amount certificates of the installment type.”

² *Ibid.*

³ *Ibid.*, p. 141.

REASONS FOR RECOMMENDATIONS

.07 The Guide's definition of an investment company quoted earlier in this Statement of Position is not met by face-amount certificate companies for the following reasons:

- (a) The business of a face-amount certificate company does not consist of "selling its capital shares to the public." Such companies (there are only four in active operation at the present time) are in the business of selling certificates which are fixed obligations and liabilities of the company.
- (b) A face-amount certificate company does not distribute to its certificate holders "the net income from, and the net gains realized on sales of, its investments."
- (c) A face-amount certificate company does not pool funds obtained from its shareholders. It pools the funds obtained from its certificate holders with the hope that the investments made will both satisfy the company's obligations to those certificate holders and result in a profit for shareholder(s).

.08 Because of these essential differences between face-amount certificate companies and investment companies, which were not recognized in the Guide, it is not appropriate to define face-amount certificate companies as a type of investment company for the purposes of the Guide and, therefore, such companies should not be required to follow the accounting provisions of the Guide.

➤➤➤ ➔ *The next page is 17,901.* ➤➤➤

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 subsequent 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.

Statements of Position

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

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They 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 and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

**ACCOUNTING PRACTICES OF
REAL ESTATE INVESTMENTS TRUSTS *****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

* See also section 10,170.

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.

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 REITs are subject to the usual risks associated with loans, investments in real estate, and commitments to make loans. These risks include adverse changes in economic conditions, both national and local, changes in interest rates, availability of mortgage financing, supply and demand for properties in specific areas, and governmental actions such as zoning and environmental regulations, among many others.

.09 REIT industry practices vary considerably with respect to providing for losses resulting from their lending activities. The Division believes it is desirable to narrow the range of acceptable practices.

.10 When it appears that an original borrower will be unable to make the payments required by the terms of his loan agreement, a REIT has several alternatives. It can place the loan in a "work-out" status with the expectation that its financial position with respect to the loan will be improved through careful monitoring of the borrower's activities coupled with continued advances on the loan when necessary. It may renegotiate the terms of the loan with the original borrower with the hope that more liberal lending terms will insure at least partial recovery of principal and interest. It may search for another borrower to assume management of the real estate collateralizing the loan and to assume responsibility for the loan. It may initiate foreclosure proceedings or accept a deed in lieu of foreclosure to obtain title to the property collateralizing the loan.

.11 Depending on the state in which property is located and depending on the complexity of a borrower's financial arrangements, foreclosure proceedings may be time consuming. However, once foreclosure has been effected, the REIT has two alternative courses of action: to dispose of the property or to hold it for investment. In either case, the REIT may have to invest additional funds to bring the property to salable and/or income-producing condition.

.12 Whether a loan appears to be "good" or "troubled" and whether a REIT elects to foreclose on a troubled loan or chooses one of the other alternatives mentioned above, it is in all cases not so much the credit standing of the borrower which is studied in determining recoverability as it is the real estate which serves as collateral for the loan. The reason for this is that in few cases would a REIT's borrower be able (or willing) to repay a loan from other sources.

.13 Accordingly, the Division believes that the essential problem to be addressed relates to the valuation of real estate and that the conclusions reached in this Statement of Position are equally applicable to the determination of allowances for losses on loans (both "good" and "troubled") and on foreclosed

properties.¹ In addition, the initial valuation method should be the same for foreclosed properties held for resale and those held as an investment.² The Division's objective is to identify a method of providing for losses which will result in an allowance which is, in the aggregate, reasonable in the context of the financial statements taken as a whole. [As amended by Statement of Position No. 78-2.] (See section 10,170.)

.14 Three methods for determining a provision for loan losses for REITs have been predominantly followed in practice, as discussed below.

Systematic Provision—Some REITs establish a provision for losses in what is considered to be a systematic manner. The most common methods are to base the provision on a fixed percentage of loans or net income.

Individual Evaluation—Some REITs establish a provision for losses based on an evaluation of the individual loans or foreclosed properties to estimate the amount of any loss that may reasonably be expected.

Combination Method—Other REITs record a provision for losses equivalent to an amount determined by evaluation of at least certain major or problem loans and foreclosed properties, increased by a provision which generally represents a percentage of loans or of net income.

.15 The Division believes that the allowance for losses should now be determined based on an evaluation of the recoverability of individual loans and properties which gives consideration to the facts and circumstances in existence at the time of the evaluation and to reasonable probabilistic estimates of future economic conditions and other relevant information. The allowance should not be determined on the basis of percentages of loan balances, income or other similar bases.

¹ Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, prescribes the accounting required for assets received or transferred in troubled debt restructurings consummated after December 31, 1977, with earlier application encouraged. The recommendations in this section, "Losses from Loans," concerning loans and properties have been amended in certain respects to conform with FASB Statement No. 15. (See "Assets Affected by Troubled Debt Restructurings.") The recommendations in this section continue to apply to foreclosed properties acquired before the effective date of FASB Statement No. 15 and for which earlier application of that Statement is not elected.

² See, however, paragraph .27 for additional comments with respect to foreclosed property held as a long-term investment.

.16 Because of the many factors which can affect recoverability, the *estimated* loss on an individual loan or property may not be the same as the ultimate loss, if any, *actually* sustained on each. While the individual evaluation method, like all estimation methods, inherently lacks precision, it best achieves, in the Division's view, the ultimate objective of determining an allowance for losses which is, in the aggregate, reasonable in the context of the financial statements taken as a whole.

.17 Evaluation of the recoverability of individual loans and properties entails a comparison of the carrying amount (including recorded accrued interest, but not previously determined allowances for losses) of each such loan or property with its estimated net realizable value. With respect to a REIT, estimated net realizable value means the estimated selling price a property will bring if exposed for sale in the open market, allowing a reasonable time to find a purchaser, reduced by (a) the estimated cost to complete and improve such property to the condition used in determining the estimated selling price, (b) the costs to dispose of the property, and (c) the estimated costs to hold the property to the estimated point of sale, including interest, property taxes, legal fees and other cash requirements of the project. However, some REITs, because of liquidity problems or for other reasons, may not be able or willing to hold foreclosed property and, therefore, must estimate the selling price on an immediate liquidation basis.

.18 Some do not believe that estimated interest holding costs should be considered in the determination of estimated net realizable value. They point out that, with limited exceptions, interest has been traditionally considered a period cost. They believe that this recommended practice is a part of the broader problem of recognition of the cost of capital and argue that it is inappropriate to reach a conclusion with respect to REITs before that broader problem is resolved. In the real estate industry, interest is clearly an economic cost of holding property and, therefore, the Division does not find these arguments persuasive. In the case of a REIT, the Division believes that 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.

.19 Some would support the Division's position if it were restricted to investments which are expected to be held in excess

of a stipulated minimum period of time related to the operating cycle of a REIT. The Division does not agree with this view.

.20 The Division believes that the guidelines described below should be followed with respect to estimating interest holding costs in the determination of estimated net realizable value.

.21 The interest rate should be estimated based on the average cost of all capital (debt and equity). This rate should be calculated by dividing debt interest costs by the aggregate of equity capital and debt. Debt interest costs should normally be based on the interest rate used for accruing interest expense at the date of the balance sheet. However, information available prior to the issuance of the financial statements (e. g., renegotiation of the REIT's debt) should be considered in determining whether that rate is appropriate. The objective is to arrive at a rate which would, *in the light of existing agreements*, correspond with the rate to be used for accruing interest expense during the estimated holding period of the property.

.22 Examples of the application of these guidelines, using present value techniques, are included in the appendices to this Statement of Position.

.23 The effective rate of interest used in the calculations should be disclosed in the notes to financial statements.

.24 A minority of four members of the Accounting Standards Executive Committee dissent from the procedure recommended above for the determination of net realizable value. In their view, treating interest cost in the manner specified results in valuing an asset differently depending upon (1) the credit standing of the entity and the resultant interest rate required to be paid on debt and (2) the entity's capital structure, i. e., the mix of debt and equity. The minority believes that net realizable value should be determined by looking only to the asset and the market considerations related to it, which should result in the same measurement for any entity whose use of the asset is the same, i. e., the net realizable value of the asset should not be affected by which entity owns it or how that entity is capitalized. In this regard, they see no reason to distinguish real estate assets from other assets.

.25 As previously noted, the individual evaluation method entails a determination of the net realizable value of the property. Some factors to be considered in the valuation of property are as follows:

- (1) The current status or nature of the property and its condition.
- (2) The current actual use of the property and the future uses of the property as related to general economic conditions and the population growth in the area.
- (3) The overall suitability of the property for its current or intended use.
- (4) Various restrictions including zoning and other possibilities.
- (5) Comparable prices of other properties in the area.

.26 The individual evaluation of loans and foreclosed properties should be made as of the close of all annual and interim stockholder reporting periods.

.27 The periodic evaluation of loans and foreclosed properties may well result in a need to increase or decrease the allowance for losses with a corresponding charge or credit to income. An exception to the foregoing should be made in the case of foreclosed property which the REIT elects to hold not for sale but as a long-term investment. The net realizable value of such property at the date of foreclosure becomes its new basis, in accordance with generally accepted accounting principles for long-term investments. Subsequent 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. (See APB Statement No. 4, Paragraph 183.)

.28 The Division believes that the appropriate presentation of loans, foreclosed property held for resale, and the allowance for losses in the balance sheet would be as follows:

Loans, earning	\$xxx	
Loans, nonearning	xxx	
Foreclosed properties held for resale.....	xxx	
	<hr/>	
	\$xxx	
Allowance for losses	\$xxx	\$xxx
	<hr/>	<hr/>

.29 There are numerous conditions which may indicate that a loss will be incurred on a loan. Some of these conditions are discussed in paragraphs .30—.38.

ASSETS AFFECTED BY TROUBLED DEBT RESTRUCTURINGS

.29A Properties acquired by an REIT in a troubled debt restructuring and accounted for in accordance with FASB Statement 15 should be recorded as if they had been acquired for cash at their fair value, which becomes their cost basis for accounting purposes. Periodically thereafter the properties should be evaluated and allowances for losses should be provided in accordance with the recommendations on "Losses from Loans."

.29B When it is probable that an REIT will enter into a troubled debt restructuring with one of its *debtors* that will result in a loss determined in accordance with the provisions of FASB Statement 15 in excess of the allowance, if any, provided in accordance with the recommendation on "Losses from Loans" in this Statement, a provision should be made for the excess loss. Thereafter, until the restructuring occurs, the loan receivable should be periodically evaluated in a similar manner, and the allowance for losses should be adjusted at each evaluation date for changes in the estimated loss. In no event should the loan, less the allowance for loss, exceed its estimated net realizable value.

.29C When it is probable that an REIT will enter into a troubled debt restructuring with one of its *creditors* that will result in a loss on transfer of an identified asset (determined in accordance with FASB Statement 15) in excess of the allowance, if any, provided in accordance with the recommendations on "Losses from Loans" in this Statement, a provision should be made for the excess loss on the identified asset to be transferred net of the related gain, if reasonably determinable, on reduction of the payable that will result from the asset transfer. The Accounting Standards Division believes that it is appropriate to include the effect of the gain in providing for the additional loss, because it is the asset transfer that produces both the loss on transfer and the gain on restructuring. The provision for the excess net loss should be reported as an expense in determining income before extraordinary items. After providing for the excess net loss, the allowance for losses will be an amount that reduces the carrying amount of the identified asset to be transferred to its estimated fair value, net of the related estimated gain (not in excess of the loss on the identified asset to be transferred) on the reduction of the payable that will result from the asset transfer. In no event, however, should the identified asset

to be transferred, less the allowance for losses, exceed its estimated net realizable value. The notes to the REIT's financial statements should disclose the effect on the allowance for losses of the estimated gain on the payable to be restructured as described in the preceding sentence. Also, the note should state that, when realized, such gain will be reported as an extraordinary item with a corresponding charge to income before the extraordinary item.

[As amended by Statement of Position 78-2.] (See section 10,170.)

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 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 A commitment fee can be defined generally as any fee paid by a potential borrower to a potential lender for a promise

to lend money in the future. Recording commitment fees is complicated by the fact that some commitments (such as many gap and stand-by commitments) are not expected to be funded.

.40 A REIT may enter into a commitment agreement without having specifically earmarked funds to honor that commitment and it may have no expectation of ever having to honor the commitment. However, circumstances beyond the control of the REIT can change drastically and the REIT may be called upon to honor the commitment.

.41 While the Division agrees that it may be possible to distinguish between commitments which are expected to be funded and those which are not, it believes that it is not possible to make such a distinction on a practical basis.

.42 The available alternatives for the recognition of income from commitment fees are listed below.

- (1) Immediate recognition
- (2) Deferral and amortization—
 - (a) Over the commitment period
 - (b) Over the combined commitment and loan period
 - (c) Over the loan period
- (3) Deferral with immediate recognition when it is clear the commitment will not be funded or with recognition as “points” when the commitment is funded

.43 In general, industry practice has been to recognize commitment fees immediately upon receipt.

.44 Those who would defer the fee over the commitment period—whether amortizing it during that period or making a decision as to appropriate accounting at the end of that period—relate the fee to the commitment itself. Those who would defer the fee and amortize it over the loan period consider the fee an adjustment of the interest on the loan.

.45 Others argue that the fee may be a combination of an adjustment of interest, a fee for ear-marking funds, and/or an offset to the underwriting costs. They believe it is not practicable to separate the components and amortizing the fee over the combined commitment and loan period more closely accounts for all three components on an overall basis.

.46 The Division believes that this latter view should now be regarded as appropriate for a REIT. The straight-line

method of amortization should be used during the commitment period and the interest method should be used for the remaining balance during the loan period.¹ Deferred commitment fees should be taken into income at the end of the commitment period if the loan is not funded.

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 account-

¹ If the commitment period were 24 months and the loan period were 25 years (300 months), monthly amortization during the commitment period would be 1/324 of the commitment fee.

ing by a REIT for operating support from its adviser would include the following:

- (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

This appendix illustrates the accounting by a REIT for a loan on a project in the development stage when the developer is unable to complete the project. Evaluation of the carrying value of the loan requires the determination of the estimated selling price of the property and estimated costs to complete construction, to carry the project to the point of disposition, and to dispose of the property. The required allowance for loan losses is determined by comparing the loan receivable balance with the discounted value of estimated future net cash receipts and disbursements.

Assumptions

• Loan receivable balance at evaluation date—	\$ 20,500,000
• Estimated selling price of the property when completed in three years, reduced by estimated costs of disposal—.....	\$ 35,000,000
• Construction and carrying costs to complete, exclusive of interest—	
Year 1 (\$416,667 monthly)	\$5,000,000
Year 2 (\$250,000 monthly)	3,000,000
Year 3 (\$ 83,333 monthly)	1,000,000
	\$ 9,000,000

- Capitalization of REIT—

Debt (average rate is 12%).....	\$300,000,000
Equity	60,000,000
Total	<u>\$360,000,000</u>

Accordingly, the average cost of all capital is 10% (12% of \$300,000,000 ÷ \$360,000,000).

- Construction and carrying costs are incurred ratably throughout each year. There is no occupancy prior to disposition.
- The REIT intends to support the project until disposition and to recover its loan on a work-out basis, and it has the financial capacity to do so.

Determination of Required Allowance for Loan Losses

Loan receivable balance	\$20,500,000
Less present value of estimated future net cash receipts and disbursements, exclusive of interest, at the average cost of all capital (10%) (Note a).....	17,870,000
Required allowance for loan losses	<u>\$ 2,630,000</u>
* * * * *	

Computational Notes (Note b)

Present value of estimated future cash receipts ($\$35,000,000 \times .7417$) =	\$25,960,000
Present value of estimated future cash disbursements—	
\$416,667 \times 11.3745 \times 1.0000 =	\$ 4,739,000
\$250,000 \times 11.3745 \times .9052 =	2,574,000
\$ 83,333 \times 11.3745 \times .8194 =	777,000
	<u>\$ 8,090,000</u>
	<u>\$17,870,000</u>

Notes—

- (a) Determining the required allowance for loan losses by deducting the present value of estimated future net cash receipts from the loan receivable balance at the evaluation date in effect builds into the calculation the interest costs to carry the project to the point of disposition.
- (b) See Appendix C for present value factors.

.54

APPENDIX B: ILLUSTRATION B

Purpose of Illustration

This appendix illustrates the accounting by a REIT for a loan on a completed multi-unit apartment project in the rent-up stage when the cash flow to the developer before debt service is insufficient to meet the required payments on the REIT's loan. Evaluation of the carrying value of the loan requires determination of the estimated selling price of the property and estimated net cash inflows and outflows from rental operations, giving effect to projected occupancy rates. The required allowance for loan losses is determined by comparing the loan receivable balance with the discounted value of estimated future net cash receipts and disbursements.

Assumptions

• Loan receivable balance at evaluation date —	\$ 4,500,000
• Occupancy is estimated to average 40% in the first year, 70% in the second year, and 95% thereafter. Occupancy rates are determined after allowing for turn-over. Monthly rentals are estimated to be \$200 per unit (300 units).	
• Estimated selling price of the property at 95% occupancy with capitalization of operating cash flow at 10%—.....	\$ 4,620,000
• Capitalization of REIT—	
Debt (average rate is 12%).....	\$100,000,000
Equity	50,000,000
Total	\$150,000,000

Accordingly, the average cost of all capital is 8% (12% of \$100,000,000 ÷ \$150,000,000).

- The REIT intends to support the property for two years. At the end of that period it intends to recover its investment and to pay its lender. The REIT has the financial capacity to do so. Cash flow before debt service is estimated as follows:

Year 1 — \$ 4,400 per month

Year 2 — \$21,400 per month

- Two alternative assumptions for repayment of the REIT's lenders are illustrated: Assumption 1—Interest on debt remains at 12% for the two year period; Assumption 2—Interest on debt remains at 12% for six months but will be reduced at that point to 6% according to a contractual arrangement.

Determination of Required Allowance for Loan Losses

	<i>Assumption 1</i>	<i>Assumption 2</i>
Loan receivable balance	\$4,500,000	\$4,500,000
Less present value of estimated future net cash receipts and disbursements, exclusive of interest, at the average cost of all capital:		
Selling price	\$3,939,000	\$4,181,000
Operating cash flow	278,000	293,000
	<u>\$4,217,000</u>	<u>\$4,474,000</u>

	<i>Assumption 1</i>	<i>Assumption 2</i>
Required allowance for loan losses.....	\$ 283,000	\$ 26,000
	<u> </u>	<u> </u>
* * *	* * *	

Computational Notes

Present value of selling price—

Estimated selling price	\$4,620,000	\$4,620,000
	<u> </u>	<u> </u>

Present value fac-
tors—

8% (average cost of capital) for 24 months .....	.8526	
8% (average cost of capital) for 6 months .....		.9609
4% (average cost of capital) for 18 months .....		.9419
	\$3,939,000	\$4,181,000
	<u> </u>	<u> </u>

Present value of net operating cash flow, before debt
service—

<i>Year 1</i>		
Monthly cash flow	\$ 4,400	\$ 4,400
Present value fac- tor	11.4958	5.8625
	<u> </u>	<u> </u>
		\$ 26,000
		<u> </u>
Monthly cash flow		\$ 4,400
Present value fac- tor		(5.9306 × .9802)
		<u> </u>
		\$ 26,000
		<u> </u>
	\$ 51,000	\$ 52,000
	<u> </u>	<u> </u>

	<i>Assumption 1</i>	<i>Assumption 2</i>
<i>Year 2</i>		
Monthly cash flow	\$ 21,400	\$ 21,400
Present value factor	(11.4958 × .9234)	(11.7440 × .9609)
	<u>\$ 227,000</u>	<u>\$ 241,000</u>
	<u>\$ 278,000</u>	<u>\$ 293,000</u>

Note—See notes (a) and (b) on page 17,916.

.55 APPENDIX C: PRESENT VALUE FACTORS

Present Value of \$1

<i>Annual Rate</i>	<i>Periods *</i>	<i>Factor</i>
10%	12	.9052
10%	24	.8194
10%	36	.7417
8%	6	.9609
8%	12	.9234
8%	24	.8526
4%	6	.9802
4%	12	.9609
4%	18	.9419

Present Value of \$1 Per Period

<i>Annual Rate</i>	<i>Periods *</i>	<i>Factor</i>
10%	12	11.3745
8%	6	5.8625
8%	12	11.4958
4%	6	5.9306
4%	12	11.7440

* Interest compounded monthly.

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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

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They 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 and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

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."¹ 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

¹ Employee Retirement Income Security Act of 1974, Title II, Subtitle B, Section 2003.

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.
- (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.² 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

² This Statement of Position does not deal directly with ESOPs that might invest in qualifying employer securities other than equity securities.

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 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 ex-

pense by the employer.³ 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.

³ 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.

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 is charged to expense, irrespective of the accounting for the normal investment tax credit on property acquisitions.⁴ This additional credit arises from the contribution to the ESOP, not solely from the property acquisitions of the employer.⁵

Applicability of APB Opinion No. 11

.15 Excess contributions, as defined, made in any one year may be carried over to future periods for income tax purposes. The Division believes that the financial statements of the employer should reflect the tax effect of timing differences in accordance with APB Opinion No. 11.⁶

ACCOUNTING STANDARDS DIVISION

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⁴ See footnote 3.

⁵ See also Section 101(c) of the Revenue Act of 1971.

⁶ See footnote 3.

Section 10,140***Statement of Position 77-1
Financial Accounting and
Reporting by Investment Companies*****[Proposal to Financial Accounting Standards Board to Amend AICPA
Industry Audit Guide on Audits of Investment Companies]****AICPA****American Institute of Certified Public Accountants**

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April 15, 1977

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position of the Accounting Standards Division proposes changes to the AICPA Industry Audit Guide on Audits of Investment Companies to give effect to developments that have taken place since the Guide was published in 1973. It was prepared on behalf of the Division by the Accounting Standards Task Force on Investment Companies for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement includes a section on money-market funds, which were not discussed specifically in the Guide. This section suggests reporting formats suitable for reporting the changes in net assets of money-market funds and provides guidance with respect to the presentation of the per-share data included in the financial statements as "Supplementary Information." In addition, the section contains recommendations on accounting and reporting for gains and losses on short-term investments.

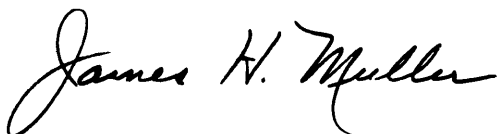
The advent of listed options has increased trading volume significantly, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Statement recommends that the sections of the Guide dealing with put and call options should be superseded. The Statement includes an expanded glossary, a discussion of industry practices, and recommendations on appropriate accounting and disclosure.

In recent years, a significant number of no-load funds, particularly money-market funds, have borne their own organization expenses. The Statement concludes, among other things, that expenses incurred by a newly organized open-end investment company in preparing its initial registration statement and obtaining clearance of such registration statement by the SEC should be considered part of its organization expense and accounted for as such. Expenses incurred after that registration statement has been declared effective by the SEC, such as printing a supply of prospectuses to be used for sales purposes, are not organization expenses. The Statement also contains recommendations with respect to the amortization of costs deferred by an investment company.

Finally, the Statement proposes an amendment to the discussion in the Guide of the valuation of short-term investments to make it clear that all investments, including short-term investments (money-market instruments), should be carried at amounts that approximate market or fair value.

Members of the Task Force will be glad to meet with you or your representatives to discuss this proposal. The Task Force would also appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,



James H. Muller
Chairman
Accounting Standards Task Force on
Investment Companies

cc: Securities and Exchange Commission

➡➡➡ *The next page is 18,265.* ⬅⬅⬅

NOTES

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 these Guides, AICPA Task Forces 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 Task Force.

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 such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force 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 Task Force believes would be in the public interest.

Accounting Standards Task Force
on Investment Companies

JAMES H. MULLER, <i>Chairman</i>	WILLIAM T. KENNEDY
CHARLES ADAMS	DAVID A. O'KEEFE
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EDWIN N. HANLON	

THOMAS P. KELLEY, *Director*
Accounting Standards

FINANCIAL ACCOUNTING AND REPORTING BY INVESTMENT COMPANIES

Proposed Amendment to Industry Audit Guide

INTRODUCTION

.01 The AICPA Industry Audit Guide, *Audits of Investment Companies*, notes that "changes in the rules, regulations, practices, and procedures of the investment company industry have been frequent and extensive in recent years" and that "further changes are under consideration." A number of changes and new developments have taken place since the Guide was published in 1973 which the Accounting Standards Division believes should be reflected in an amendment to the Guide.

.02 This proposed amendment presents the Division's views on the following matters:

- Money-market funds (an addition to the Guide)
- Put and call options (supersedes discussion in the Guide)
- Expenses during the development stage (an addition to the Guide)
- Amortization of deferred costs (an addition to the Guide)
- Valuation of short-term investments (an amendment to the Guide)

.03 The Guide includes collective trust funds within its general definition of investment companies, but has no discussion of regulatory and tax matters specifically applicable to such funds. Although collective trust funds are not investment companies within the definition of the Investment Company Act of 1940 and are not regulated under the Securities Acts, the accounting and auditing discussions in the Guide are applicable to such funds, where relevant. In addition, the auditor should be familiar with Regulation 9 of the Comptroller of the Currency, which is the regulatory standard for most collective funds operated by banks, and Subchapter H of the Internal Revenue Code, which contains rules for the specialized tax treatment of collective funds.

MONEY-MARKET FUNDS

Background

.04 Money-market funds are open-end management investment companies that invest principally in money-market instruments (short-term government obligations, commercial paper, bankers' acceptances, certificates of deposit, and so forth) with the objective of preserving capital, maintaining liquidity, and obtaining current income. As such, money-market funds are subject to the provisions of the AICPA Industry Audit Guide, *Audits of Investment Companies*.

.05 At the time the Guide was published in October 1973, only a few money-market funds were in operation, and the Guide did not discuss such funds specifically. However, many more have commenced operations since that date, and the Division believes that specific guidance for money-market funds is now desirable.

Distribution Policies

.06 Many money-market funds declare dividends daily, thereby maintaining net asset value per share at or near a fixed amount, depending on which of the following distribution policies is adopted.

<u>Distribution Policy</u>	<u>Effect on Net Asset Value per Share</u>
(a) Define income for dividend purposes as the sum of net investment income, net realized gain (loss), and net unrealized appreciation (depreciation). If income, as defined, is a negative amount for any day, that amount is first offset against undistributed dividends accrued during the month in each shareholder's account. If a negative amount remains in a shareholder's account, outstanding shares are reduced by treating each such shareholder as having contributed shares to the fund to the extent of such negative amount.	Net asset value remains fixed.
(b) Define income as in (a) above, but take no action for any day in which such income is a negative amount.	Net asset value remains fixed unless income, as defined, is a negative amount, in which case net asset value will be less than the fixed amount until restored to the fixed amount through subsequent income, as defined.

<u>Distribution Policy</u>	<u>Effect on Net Asset Value per Share</u>
(c) Define income for dividend purposes as the sum of net investment income and net realized gain (loss).	Net asset value varies from the fixed amount to the extent of unrealized appreciation or depreciation. Also, it is reduced if income, as defined, is a negative amount that is not offset by unrealized appreciation (net realized loss exceeds net investment income and unrealized appreciation).
(d) Declare daily dividends from net investment income only; distribute net realized gain annually.	Net asset value varies from the fixed amount to the extent of the sum of undistributed realized gain (loss) and unrealized appreciation (depreciation).

.07 Long-term capital gains, as defined in the Internal Revenue Code, may be distributed only once every 12 months unless a specific exemption is obtained.¹ Therefore, a fund that expects to realize long-term gains and that wishes to follow distribution policy (a), (b), or (c) will need to request exemption from Section 19(b) of the 1940 Act to avoid adverse consequences.

.08 See paragraphs .46-.47 of this Statement for a discussion of the valuation of short-term investments.

Statement of Changes in Net Assets

.09 A modification of the format suggested in the Guide for the Statement of Changes in Net Assets is required to report clearly the effects of following one of the distribution policies described in (a), (b), or (c) in the preceding section.

.10 A fund that follows distribution policy (a) or (b) should include a subtotal for net investment income and net realized gain (loss) and unrealized appreciation (depreciation) in the Statement of Changes in Net Assets. This subtotal represents income as defined for dividend purposes.

¹ Section 19(b) and Rule 19b-1 of the Investment Company Act of 1940.

.11 The following format is appropriate for the Statement of Changes in Net Assets (shown in part) of a money-market fund that has adopted distribution policy (a) or (b).

From Investment Activities	<u>19X1</u>	<u>19X0</u>
Net investment income	\$100,000	\$80,000
Net realized gain (loss) on investments	2,000	(1,000)
Increase (decrease) in unrealized appreciation of investments	(3,000)	1,000
Total available for distribution	<u>\$ 99,000</u>	<u>\$80,000</u>
Dividends declared	<u>99,500</u>	<u>80,000</u>
Decrease in assets derived from investment activities ²	<u>\$ (500)</u>	<u>—</u>

.12 The following format is suggested for the Statement of Changes in Net Assets (shown in part) of a money-market fund that follows distribution policy (c); that is, it distributes the sum of net investment income and net realized gain or loss daily.

From Investment Activities	<u>19X1</u>	<u>19X0</u>
Net investment income	\$100,000	\$80,000
Net realized gain (loss) on investments	2,000	(1,000)
Total available for distribution	<u>\$102,000</u>	<u>\$79,000</u>
Dividends declared	<u>(102,000)</u>	<u>(79,000)</u>
Increase (decrease) in unrealized appreciation of investments	(3,000)	1,000
Increase (decrease) in net assets derived from investment activities	<u>\$ (3,000)</u>	<u>\$ 1,000</u>

² A decrease in net assets derived from investment activities would be reported by a company following distribution policy (b) only if the company incurred a net loss (realized and unrealized) on investments that was not offset by net investment income and net gains (realized and unrealized) prior to the end of the reporting period.

.13 Money-market funds that follow distribution policy (d), or that do not declare dividends daily, should follow the presentation on page 101 of the Guide.

Supplementary Information

.14 The per-share data included in the financial statements as “Supplementary Information” should be presented on a basis consistent with the presentation of the Statement of Changes in Net Assets, as illustrated or discussed above.³ A fund that follows distribution policy (a) and that has treated each shareholder as having contributed shares to the fund when income, as defined, is a negative amount, should include an additional line item in the per-share data to show the effect of such action.

.15 The investment policies of money-market funds are such that gains and losses, whether realized or unrealized, are usually incidental to the realization of investment income. Also, the dividend policy adopted by a fund should have no effect on the reported ratio of income to average net assets, because the purpose of the ratio is to indicate the effective rate of earnings, regardless of when the earnings are distributed. Accordingly, the most significant ratio for a money-market fund to report is the ratio of net investment income, plus or minus realized and unrealized gains or losses, to average daily net assets. When supplementary information is provided by a money-market fund, this ratio should be reported instead of the ratio of net investment income to average net assets, which is included in the illustration of “Supplementary Information” in the Guide.

.16 It may be appropriate for a fund that distributes only net investment income (distribution policy (d)) to provide a breakdown of the ratio, in a footnote or parenthetically, indicating the portion applicable to realized and unrealized gains or losses, if they are significant.

.17 When yield information is presented as “Supplementary Information” or elsewhere in the financial statements, a description of the method of computation should be provided.

³ Income (as defined) per share should be based on the per-share dividends declared during the period and prorated by components based on the amounts shown in the Statement of Operations. For example, a fund following distribution policy (a) or (b) would apportion its per-share income (as defined) between net investment income and realized and unrealized gain (loss).

Reporting Gains and Losses

.18 When short-term investments, including discounted instruments, are sold prior to maturity, realized gains and losses should be recorded as such, based on the difference between the proceeds from sale and cost (amortized cost in the case of discounted instruments). However, net realized gains or losses are ordinarily not significant in relation to the total dollar amount of sales of money-market instruments. Further, such gains or losses are rarely significant in relation to the results of operations of a money-market fund. Accordingly, except in unusual circumstances, a money-market fund need not report the proceeds from sales and the cost of securities sold in the Statement of Operations; it need report therein only the amount of net realized gain or loss.

.19 Changes in unrealized appreciation or depreciation should be reported following the presentation on page 100 of the Guide.

Federal Income Taxes

.20 A fund that includes unrealized appreciation or depreciation in dividends may have distributed more or less than its taxable income in a particular year. Accordingly, a fund that follows such a policy should pay particular attention to the provisions of the Internal Revenue Code relating to the distribution of taxable income, as discussed more fully in chapter 5 of the Guide.

PUT AND CALL OPTIONS

Background

.21 An active public market has been developed in listed call options, and trading in listed put options is expected in early 1977. Although there has been an over-the-counter market in options for many years and the public has participated to some degree, the advent of listed options has increased trading volume significantly, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Division believes that the sections of *Audits of Investment Companies* covering options should be amended to give appropriate guidance with respect to an investment company that purchases or sells options. This Statement of Position supersedes the following sections of the Guide:

- Valuation of Put and Call Options Purchased (chapter 3, "Investment Accounts," page 37)
- Valuation of Put and Call Option Contracts Written by the Investment Company (chapter 3, "Investment Accounts," page 38)
- Put and Call Options (chapter 5, "Taxes," page 69)

Option Trading

.22 The following glossary of terms should be helpful in understanding the mechanics of option trading.

Exchange-Traded Option. A put or call option traded on an exchange and settled through the facilities of an exchange. It gives the buyer of the option ("holder") the right to sell to (put) or buy from (call) the seller ("writer") the number of shares or other units of the underlying security covered by the option at the stated exercise price prior to the fixed expiration date of the option. The designation of an option includes the underlying security, the expiration month, and the exercise price; for example, "XYZ July 50" means that a unit of trading (typically 100 shares) of XYZ stock may be sold or purchased at \$50 per share until the option expires on the expiration date in July. Options of like designation are said to be of the same "series."

Underlying Security. The security subject to sale or purchase upon the exercise of the option.

Unit of Trading. The number of units of the underlying security designated as the subject of a single option. In the absence of any other designation, the unit of trading for a common stock is 100 shares.

Exercise Price. The price per share or other unit at which the holder of an option may sell or purchase the underlying security upon exercise. The exercise price is sometimes called the "striking price."

Expiration Date. The last day on which an option may be exercised.

Premium. The aggregate price of an option agreed upon between the buyer and writer or their agents.

Opening Purchase Transaction. A transaction in which an investor becomes the holder of an exchange-traded option.

Opening Sale Transaction. A transaction in which one becomes the writer of an exchange-traded option.

Closing Purchase Transaction. A transaction in which a writer of an exchange-traded option liquidates his position as a writer by "purchasing," in a transaction designated as a closing purchase transaction, an option having the same terms as the option previously written. Such a transaction has the effect, upon payment of the premium, of canceling the writer's pre-existing position instead of resulting in the issuance of an option.

Closing Sale Transaction. A transaction by which a holder of an option liquidates his position as a holder by "selling," in a transaction designated as a closing sale transaction, an option having the same terms as the option previously purchased. Such a transaction has the effect of liquidating the holder's pre-existing position instead of resulting in the holder's assuming the obligation of a writer.

Covered Writer. A writer of a call option who, as long as he remains a writer, owns the shares or other units of the underlying security covered by the option. The writer of a put is "covered" only when he purchases an option on the same underlying security with an exercise price equal to or greater than that of the option written.

Uncovered Writer. A writer of an option who is not a covered writer; sometimes referred to as "naked."

Option Writing

.23 As consideration for the rights and obligations represented by an option, the buyer pays, and the writer receives, a premium. The premium is determined in the exchanges' option markets on the basis of supply and demand, reflecting factors such as the duration of the option, the difference between the exercise price and the market price of the underlying security, and the price volatility and other characteristics of the underlying security. A covered writer of a call option gives up, in return for the premium, the opportunity for profit from an increase in the price of the underlying security above the exercise price as long as the option obligation continues, but he retains the risk of loss should the price of the security decline. Since the option holder may exercise the option and purchase the securities at the designated price at any time prior to the ex-

piration date of the option, the option writer has no control over the date of sale.

.24 An uncovered writer of a call option assumes, in return for the premium, the obligation to provide the option holder with the underlying securities upon exercise of the option. The uncovered writer, therefore, may have a substantial risk of loss should the price of the security increase, but he has no risk of loss should the price of the security decrease.

.25 As long as a secondary market in options remains available on each of the exchanges, the writer of an option traded on an exchange is able to liquidate his position prior to the exercise of such option by entering into a closing purchase transaction. Such a transaction has the effect of canceling the writer's pre-existing position. The cost of such a liquidating purchase, however, can be greater than the premium received upon writing the original option.

.26 Because the purchaser or writer has the ability to enter into a closing transaction, the option originally written may never be exercised. The exercise of an exchange-traded option takes place only through the Options Clearing Corporation (OCC), which is the obligor on every option, by the timely submission of an exercise notice by the clearing broker acting on behalf of the exercising holder. The exercise notice is then "assigned" by the OCC to a clearing broker acting on behalf of a writer of an option of the same series as the exercised option. This broker is then obligated to deliver the underlying security against payment of the aggregate exercise price. The assigned broker is randomly selected from clearing members having accounts with the OCC with options outstanding of the same series as the option being exercised.

.27 Most investment companies deposit securities underlying the options written in order to guarantee delivery in the event the option is exercised.

Accounting

.28 Portfolio securities underlying call options should be reported at value, determined in accordance with the provisions of the Guide, and reflected in net asset value accordingly. Premiums received by an investment company from the sale of outstanding call options should be included in the liability section of the Statement of Assets and Liabilities as a deferred credit

and subsequently adjusted to the current market value (marked-to-market) of the option written. For example, if the current market value of the option exceeded the premium received (which should be shown parenthetically in the Statement of Assets and Liabilities), the excess would be an unrealized loss and, conversely, if the premium exceeded the current market value, such excess would be an unrealized gain. Current market value of exchange-traded options should be the last sales price or, in the absence of a transaction, the mean between the closing bid and ask prices, or the ask prices, in accordance with the valuation policy followed by the fund. The change in unrealized depreciation or appreciation resulting from the mark-to-market may be included with unrealized gains or losses on the portfolio in the Statement of Operations and Statement of Changes in Net Assets, with disclosure as to the amount, or it may be reported as a separate line item.

.29 With respect to covered options, disclosure, summarized by security, should be made of the description and number of shares of portfolio securities covering outstanding options and the market value of the options. Disclosure should also be made of the aggregate market value of the securities or other assets deposited as collateral. With respect to uncovered options, disclosure should be made of the description and quantity of securities under option, the expiration dates and exercise prices, the current market prices of the securities covered by the options, and the assets deposited in escrow with respect to such options.

.30 Subsequent to the sale of a call option, any one of three events may occur: the option may expire on its stipulated expiration date; the writer may enter into a closing transaction; or the option holder may exercise his right to call the security. Either of the first two events results in a realized gain (or loss if the cost of the closing transaction exceeds the premium received when the option was sold) for the investment company option writer and should be accounted for as such. The third possible event results, in the case of a covered writer, in the sale of the underlying securities, unless the writer purchases like securities for delivery to the exercising holder. The proceeds should be increased by the amount of premium originally received, and realized gains or losses resulting from such sales should be accounted for in the conventional manner. If an uncovered option is exercised, the writer must purchase the under-

lying securities in order to meet his obligation to the option holder. In such situations, the writer's realized loss resulting from the simultaneous purchase and sale of the securities should be reduced by the premium originally received, and the net realized loss (or gain) should be accounted for in the conventional manner.

.31 The foregoing describes the accounting for the sale of call options. The same principles are applicable to the sale of put options.

.32 Actively traded put and call options purchased by an investment company should be accounted for in the same manner as marketable portfolio securities. The cost of portfolio securities acquired through the exercise of call options should be increased by the premium paid to purchase the call. The proceeds from securities sold through the exercise of put options should be decreased by the premium paid to purchase the put.

.33 Transactions in options not listed on a national exchange or not actively traded should be accounted for as described in the foregoing paragraphs, except that the determination of unrealized gain or loss during the contract period of the option must be based on the fair value of the option as determined by the investment company's board of directors. Among the many factors to be considered in the determination of fair value are the price of the underlying securities, the liquidity of the market, and the time remaining prior to expiration date.

Federal Income Taxes

.34 The following paragraphs are intended to supersede only that portion of chapter 5 of the Guide ("Taxes") dealing with put and call options. Reference to that chapter should be made for other information pertinent to the taxation of investment companies.

.35 For federal income tax purposes, premium income from the sale of options is deferred until expiration or exercise of the option, or until a closing purchase transaction takes place. If the option expires, the premium constitutes a short-term capital gain. If the option is exercised and the underlying securities are sold, the premium is added to the proceeds from the sale of the securities in determining capital gain or loss. Such gain or loss is short-term or long-term depending upon the holding period

of the underlying securities. If the option is closed in a closing purchase transaction, the difference between the amount paid for the option purchased and the premium received on the original sale is a short-term capital gain or loss.⁴

.36 Under the Internal Revenue Code, an investment company cannot qualify as a regulated investment company unless, among other things, less than 30 percent of its gross income is derived from gains from the sale or other disposition of securities held for less than three months ("30 percent rule"). Therefore, in order to be taxable as a regulated investment company, its ability to write options with exercise periods of less than three months or to effect closing purchase transactions within three months of writing options is restricted. For purposes of meeting this "three-month test," the holding period for the sale of an option commences on the day it is written.

.37 An investment company must derive at least 90 percent of its gross income from dividends, interest, and gain from the sale or other disposition of stock or securities ("investment income"), in order to qualify as a regulated investment company in any taxable year. For tax purposes, income received from expired call options and from profits in executing closing purchase transactions for amounts less than the call premiums received qualifies as investment income.

EXPENSES DURING THE DEVELOPMENT STAGE

.38 The standards of financial accounting and reporting set forth in FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, are applicable to financial statements issued by investment companies that are in the development stage, as defined in the FASB Statement. The following paragraphs in this section discuss certain expenses that may be incurred by an investment company that is in the development stage.

.39 A newly formed investment company will incur organization expenses unless it is sponsored by a management company that has agreed to absorb these expenses. Organization expenses consist of expenses incurred in order to establish the company and legally equip it to engage in business. In recent years, a

⁴ The termination of a writing position that was established on or before September 1, 1976, by lapse of the option or by a closing purchase transaction, will produce ordinary income or loss.

significant number of no-load funds, particularly money-market funds, have borne their own organization expenses.

.40 An open-end investment company, which is organized to offer shares of capital stock to the public continuously and to invest the proceeds from sale of such capital stock, cannot be considered to be organized until it has registered securities with the Securities and Exchange Commission. Therefore, expenses incurred by a newly organized open-end investment company in preparing its initial registration statement and obtaining clearance of such registration statement by the SEC should be considered part of its organization expenses; expenses incurred after that registration statement has been declared effective by the SEC, such as printing a supply of prospectuses to be used for sales purposes, are not organization expenses.

.41 As stated in *Audits of Investment Companies*, "closed-end companies charge all registration fees against paid-in capital at the time the shares are sold." This Statement of Position does not modify that requirement.

.42 Once an investment company has been organized to do business, it usually engages immediately in its planned principal operations, that is, sales of capital stock and investment of funds. The training of employees, development of markets for the sale of capital stock, and similar activities are usually performed by the investment adviser or other agent, and in such cases the costs of these activities are not borne directly by the investment company. However, an investment company (particularly one that does not employ agents to manage its portfolio and perform other essential functions) may engage for a period of time in such activities, and may bear those costs directly during its development stage.

.43 As stated above, an investment company that is in the development stage is subject to the provisions of FASB Statement No. 7. Paragraph 10 of the FASB Statement notes that "generally accepted accounting principles that apply to established operating enterprises . . . 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." Accordingly, the costs and expenses discussed in the preceding paragraphs should be accounted for in accordance with the generally accepted accounting principles that apply to established operating enterprises. Organization expenses of invest-

ment companies are usually deferred and amortized in financial statements prepared in conformity with generally accepted accounting principles.

AMORTIZATION OF DEFERRED COSTS

.44 Costs deferred by an investment company should be subject to the same assessment of recoverability that would be applicable to any established operating company. Such costs should be amortized to income over the period during which it is expected that a benefit will be realized. That period may vary according to the type of expense. Several costs are listed below.

Organization Expenses. Generally such expenses are amortized over a period of not more than 60 months from the date of commencement of operations. Straight-line or other acceptable methods of amortization may be utilized.

If such expenses are amortized on the basis of assets expected to be managed over the period selected, the projected growth rate initially used as the basis for establishing an amortization table should be reviewed frequently and adjusted, if necessary, to reflect actual experience.

Cost of Printing Prospectuses. Costs deferred in connection with printing a supply of prospectuses for sales purposes should be amortized, generally on a straight-line basis, over the period during which the prospectus may be used, which is limited to a period ending 16 months after the date of the latest audited financial statements. If during this period it becomes evident that the prospectus will be effective for a shorter period than originally anticipated, amortization should be accelerated so that no costs remain deferred at the end of such shorter period.

Registration Fees. Deferred SEC and state registration fees should be written off as the registered shares of stock are sold (but over not more than 60 months).

.45 The summary in the financial statements describing an investment company's significant accounting policies should cover the company's accounting for deferred costs.

VALUATION OF SHORT-TERM INVESTMENTS

.46 The discussion of the valuation of short-term investments on page 39 of the Guide states that "original cost plus amortized

discount or accrued interest . . . usually approximates market value.” This statement was made when holdings of short-term investments generally constituted a small portion of an investment company’s portfolio. It was not intended to modify the principle that “all investment companies should report their securities portfolio at value.” In all cases, the board of directors should be satisfied that investments, including short-term investments (money-market instruments), are carried at amounts that approximate market or fair value. Accordingly, the Division believes that the discussion entitled Short-Term Investments on page 39 of the Guide should be amended by the addition of the following paragraph:

Although the amortized cost of money-market instruments that mature within a relatively short period of time ordinarily approximates market value, it must be recognized that unusual events, such as the impairment of the credit standing of the issuer, can significantly affect the value of short-term investments regardless of the number of days to maturity. Changes in interest rates can also have a significant effect on the value of money-market instruments with longer terms to maturity. In such cases, amortized cost might not approximate the value of these investments. When amortized cost does not approximate value, the investments should be valued on the basis of quoted sales prices, bid and asked prices, or fair value based upon appraisals furnished by market makers or other appropriate evidence.

➤ *The next page is 18,321.* ←➤

Section 10,160

***Statement of Position 78-1
Accounting by Hospitals for Certain
Marketable Equity Securities***

**[Proposal to Financial Accounting Standards Board to Amend AICPA
Industry Audit Guide on Audits of Hospitals]**

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

May 1, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, prepared by the AICPA Subcommittee on Health Care Matters, proposes amendments to the AICPA Industry Audit Guide on Audits of Hospitals. The statement of position will amend part of chapter 2 of the guide which deals with investment income and gains (losses).

Members of the subcommittee will be glad to meet with you or your representatives to discuss this proposal. The subcommittee would also appreciate being advised as to the board's proposed action on its recommendations.

Sincerely yours,

Albert A. Cardone

Albert A. Cardone, Chairman
Subcommittee on Health
Care Matters

➡➡➡ The next page is 18,323. ←←←

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To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force 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 subcommittee or task force believes would be in the public interest.

ACCOUNTING BY HOSPITALS FOR CERTAIN MARKETABLE EQUITY SECURITIES

.01 Statement of Financial Accounting Standards No. 12, *Accounting for Certain Marketable Securities*, issued by the Financial Accounting Standards Board, states in the first sentence of paragraph 5 that it "does not apply to not-for-profit organizations," which are those described in the Introduction to Accounting Research Bulletin No. 43. Thus, FASB Statement No. 12 applies to investor-owned hospitals and does not apply to not-for-profit hospitals.

.02 The AICPA Subcommittee on Health Care Matters believes that the *Hospital Audit Guide* should be amended by deletion of the section "Investment Income and Gains (Losses)" and inclusion of the following new section.

ACCOUNTING FOR CERTAIN MARKETABLE EQUITY SECURITIES

.03 Investor-owned hospitals are subject to the requirements of FASB Statement No. 12 and interpretations of that Statement, which specify the accounting and disclosure requirements applicable to portfolios of marketable equity securities. Under

Statement No. 12, cost is no longer an acceptable accounting method for marketable equity securities, and the carrying amount of a marketable equity security portfolio that was previously carried at cost should now be the lower of its aggregate cost and market values.¹

.04 Similarly, cost should no longer be used by not-for-profit hospitals for marketable equity securities. The carrying amount of a marketable equity security portfolio of a not-for-profit hospital that was previously carried at cost should now be the lower of its aggregate cost and market value, determined at the balance sheet date. The amounts by which the aggregate cost of each portfolio exceeds market value should be accounted for as valuation allowances.

.05 Marketable equity securities owned by a not-for-profit hospital should be grouped into separate portfolios, as indicated below, for the purpose of comparing aggregate cost and market value to determine carrying amount.

1. Marketable equity securities included in unrestricted funds should be grouped into separate portfolios according to the current or noncurrent classification of the securities.
2. Marketable equity securities included in different types of restricted funds should be grouped into separate portfolios according to types of funds (for example, portfolios of marketable equity securities included in various specific purpose funds should be grouped together but not with those in endowment funds).
3. The current portfolios of unrestricted funds of entities that are combined in financial statements should be treated as a single combined portfolio; the noncurrent unrestricted portfolios of those entities should also be treated as a single combined portfolio: similar restricted fund portfolios of entities that are combined in financial statements should be treated as single portfolios (for example, portfolios of marketable equity securities included in the various specific purpose funds of a not-for-profit hospital should be combined with the portfolios of marketable equity securities held in the various specific purpose funds of an entity whose financial statements are combined with those of the not-for-profit hospital).

¹ Reference should be made to paragraph 7 of FASB Statement No. 12 for definitions of the following terms: equity security, marketable, market price, market value, cost, valuation allowance, carrying amount, realized gain or loss, net unrealized gain or loss.

.06 If there is a change in a marketable equity security's classification between current and noncurrent assets in unrestricted funds, the security should be transferred between the corresponding portfolios at the lower of its cost and market values at the date of transfer. If market value is less than cost, the market value becomes the new cost basis, and the difference is accounted for as if it were a realized loss and is included in the nonoperating revenues section of the statement of revenues and expenses.

.07 Changes in the valuation allowance for a marketable equity securities portfolio included in current assets in unrestricted funds should be disclosed in the nonoperating revenues section of the statement of revenues and expenses. Changes in the valuation allowance for a marketable equity securities portfolio included in noncurrent assets in unrestricted funds or assets in restricted funds should be disclosed in the respective statements of charges in fund balances; accumulated changes in the valuation allowance for such portfolios should be disclosed in the appropriate fund balance in the balance sheet.

.08 If the hospital pools its investments (which could include investments of current and noncurrent unrestricted funds and investments of restricted funds), the cost of marketable equity securities in the fund(s) should be compared to the allocation of the market value of the pooled marketable equity securities for purposes of implementing the above recommendations. To apply those provisions properly, marketable equity securities and other investments must be accounted for separately.

.09 Income from investments of board-designated and other unrestricted funds and realized gains or losses on sales of investments of board-designated and other unrestricted funds should be included in the statement of revenues and expenses as nonoperating revenue of the period in which they are earned or incurred.

.10 Realized gains or losses on the sale of investments of endowment funds should be added to or deducted from endowment fund principal unless such amounts are legally available for other use or chargeable against other funds. Investment income of those funds should be accounted for in accordance with the donors' instructions—for example, as resources for specific operating purposes if restricted, or nonoperating revenue if not.

.11 Income and net realized gains or losses on investments of restricted funds other than endowment funds should be charged or credited to the respective fund balance unless such amounts are legally available for or chargeable against other funds. If such amounts are legally available for unrestricted purposes, they should be included in nonoperating revenue. Gains or losses on investment trading between unrestricted and restricted funds and between various categories of restricted funds (for example, between endowment and plant replacement funds) should be recognized as realized gains or losses and separately disclosed in the financial statements. Gains or losses resulting from transactions between various board-designated funds of the unrestricted fund should not be recognized.

.12 The following information with respect to owned marketable equity securities should also be disclosed either in the body of the financial statements or in the accompanying notes:

1. As of the date of each balance sheet presented, aggregate cost and market values for each separate portfolio into which marketable equity securities were grouped to determine carrying amount, with identification of which is the carrying amount.
2. As of the date of the latest balance sheet presented, the following segregated by portfolio—
 - a. Gross unrealized gains representing the excess of market value over cost for all marketable equity securities having such an excess in the portfolio.
 - b. Gross unrealized losses representing the excess of cost over market value for all marketable equity securities having such an excess in the portfolio.
3. For each period for which a statement of revenues and expenses is presented—
 - a. Net realized gain or loss included in nonoperating revenue.
 - b. The basis on which cost was determined in computing realized gain or loss (average cost or other method).

.13 The financial statements should not be adjusted for realized gains, losses, or changes in market prices with respect to marketable equity securities if such gains, losses, or changes occur after the date of the financial statements but before their issuance, except for the situation covered in the following para-

graph. However, significant net realized and net unrealized gains and losses arising after the date of the financial statements but before their issuance applicable to marketable equity securities owned at the date of the most recent balance sheet should be disclosed.

.14 For those marketable securities for which the effect of a change in carrying amount is included in the statement of changes in fund balances rather than in the statement of revenues and expenses, a determination should be made as to whether a decline in market value below cost as of the balance sheet date of an individual security is other than temporary. If the decline is judged to be other than temporary, the cost basis of the individual security should be written down to a new cost basis and the amount of the write-down should be accounted for as a realized loss. The new cost basis should not be changed for subsequent recoveries in market value.

.15 Unrealized gains or losses should not result in adjustment of financial statements, except for changes in the valuation allowance related to marketable equity securities and for declines in value that result from other than temporary impairment.

.16 The disclosures in Note 1 to the sample financial statements on page 48 of the *Hospital Audit Guide* should conform with the disclosures set forth in this amendment.

TRANSITION

.17 The subcommittee recommends that this amendment be applied to financial statements for fiscal years beginning on or after the first day of the first month following the date of this Statement and encourages earlier application. If the initial application of this Statement requires the establishment of a valuation allowance, financial statements previously issued should not be restated. If the establishment of a valuation allowance is required for a marketable equity securities portfolio included in current assets in unrestricted funds, the effect of the change should be included in the determination of the excess of revenue over expense for the period of the change in accordance with the provisions of APB Opinion 20. If the establishment of a valuation allowance is required for a marketable equity securities portfolio included in noncurrent assets in unrestricted funds or assets in restricted funds, the effect of the change should be presented in the statement of changes in fund balances.

SUBCOMMITTEE ON HEALTH CARE MATTERS

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The subcommittee gratefully acknowledges the contributions made to the development of this Statement of Position by former members of the subcommittee, Robert A. Cerrone, William Freitag, and Robert F. Rosenstiel.

➤➤➤ *The next page is 18,351.* ←➤➤➤

Section 10,170***Statement of Position 78-2
Accounting Practices of Real
Estate Investment Trusts***

[Proposal to Financial Accounting Standards Board to Amend Statement of Position 75-2]

AICPA**American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

May 12, 1978

Donald J. Kirk
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting Practices of Real Estate Investment Trusts, an Amendment of Statement of Position 75-2, was prepared on behalf of the division by the AICPA's Committee on Real Estate Accounting for consideration of the Financial Accounting Standards Board and for such action as the board deems appropriate. It amends Statement of Position 75-2 to conform the recommendations of that statement to the provisions of Statement of Financial Accounting Standards 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience. The division would appreciate being advised on the board's proposed action on the

recommendations set forth in this statement of position.

Sincerely,

A handwritten signature in dark ink, appearing to read "Arthur R. Wyatt", with a stylized flourish at the end.

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of Position of the AICPA Accounting Standards Division are issued for the general information of those interested in the subject. They 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 and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING PRACTICES OF REAL ESTATE INVESTMENT TRUSTS

INTRODUCTION

.01 The recommended accounting for real estate loans and foreclosed properties in Statement of Position (SOP) 75-2 [section 10,060], *Accounting Practices of Real Estate Investment Trusts*, issued June 27, 1975, is inconsistent with certain provisions of Statement of Financial Accounting Standards 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, issued by the Financial Accounting Standards Board in June 1977.

.02 In the section of SOP 75-2 [section 10,060] entitled "Losses from Loans," the Accounting Standards Division recommended that real estate investment trusts (REITs) periodically evaluate individual real estate loans and foreclosed properties held for sale and provide allowances for losses to adjust the carrying amounts of the individual assets at each evaluation date to their estimated net realizable value (as defined in the SOP) or, in the case of foreclosed properties, to their estimated selling price on an immediate liquidation basis if the REIT is unable or unwilling to hold the properties because of liquidity problems or other reasons. The Division recommended that the net realizable value at the date of foreclosure should become the cost basis of a foreclosed property that an REIT elects to hold as a long-term investment.

.03 FASB Statement 15 prescribes the accounting by debtors and creditors, including REITs, for troubled debt restructurings consummated after December 31, 1977. Paragraph 2 of that Statement contains the following definition of a troubled debt restructuring:

A restructuring of a debt constitutes a *troubled debt restructuring* for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.

A note to that paragraph states:

Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term *troubled debt restructuring* in this Statement.

Among other things, the Statement requires assets received or transferred in a troubled debt restructuring to be valued at their fair value (as defined in the statement) when the restructuring occurs. (See paragraphs 13, 14, 19, 20, 28, 29, 33, 34, 35, and 42 of that Statement.) The fair value of a property as measured under FASB Statement 15 may differ materially from its net realizable value as measured under the recommendations on losses from loans in Statement of Position 75-2 [section 10,060].

.04 The Accounting Standards Division believes that SOP 75-2 [section 10,060] should be amended, as set forth below, to conform its recommendations to the provisions of FASB Statement 15.

THE DIVISION'S CONCLUSIONS

.05 The following footnote referenced to "foreclosed properties" in the first sentence of the sixth paragraph under the caption "Losses from Loans" is added to SOP 75-2 [section 10,060].

Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, prescribes the accounting required for assets received or transferred in troubled debt restructurings consummated after December 31, 1977, with earlier application encouraged. The recommendations in this section, "Losses from Loans," concerning loans and properties have been amended in certain respects to conform with FASB Statement No. 15. (See "Assets Affected by Troubled Debt Restructurings.") The recommendations in this section continue to apply to foreclosed properties acquired before the effective date of FASB Statement No. 15 and for which earlier application of that Statement is not elected.

.06 The following section, "Assets Affected by Troubled Debt Restructurings," is added to SOP 75-2 [section 10,060] to follow immediately after the section "Losses from Loans."

Assets Affected by Troubled Debt Restructurings

Properties acquired by an REIT in a troubled debt restructuring and accounted for in accordance with FASB Statement 15 should be recorded as if they had been acquired for cash at their fair value, which becomes their cost basis for accounting purposes. Periodically thereafter the properties should be evaluated and allowances for losses should be provided in accordance with the recommendations on "Losses from Loans."

When it is probable that an REIT will enter into a troubled debt restructuring with one of its *debtors* that will result in a loss determined in accordance with the provisions of FASB Statement 15 in excess of the allowance, if any, provided in accordance with the recommendation on "Losses from Loans" in this Statement, a provision should be made for the excess loss. Thereafter, until the restructuring occurs, the loan receivable should be periodically evaluated in a similar manner, and the allowance for losses should be adjusted at each evaluation date for changes in the estimated loss. In no event should the loan, less the allowance for loss, exceed its estimated net realizable value.

When it is probable that an REIT will enter into a troubled debt restructuring with one of its *creditors* that will result in a loss on transfer of an identified asset (determined in accordance with FASB Statement 15) in excess of the allowance, if any, provided in accordance with the recommendations on "Losses from Loans" in this Statement, a provision should be made for the excess loss on the identified asset to be transferred net of the related gain, if reasonably determinable, on reduction of the payable that will result from the asset transfer. The Accounting Standards Division believes that it is appropriate to include the effect of the gain in providing for the additional loss, because it is the asset transfer that produces both the loss on transfer and the gain on restructuring. The provision for the excess net loss should be reported as an expense in determining income before extraordinary items. After providing for the excess net loss, the allowance for losses will be an amount that reduces the carrying amount of the identified

asset to be transferred to its estimated fair value, net of the related estimated gain (not in excess of the loss on the identified asset to be transferred) on the reduction of the payable that will result from the asset transfer. In no event, however, should the identified asset to be transferred, less the allowance for losses, exceed its estimated net realizable value. The notes to the REIT's financial statements should disclose the effect on the allowance for losses of the estimated gain on the payable to be restructured as described in the preceding sentence. Also, the note should state that, when realized, such gain will be reported as an extraordinary item with a corresponding charge to income before the extraordinary item.

ACCOUNTING STANDARDS DIVISION

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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,

A handwritten signature in black ink, reading "Arthur R. Wyatt". The signature is fluid and cursive, with the first name "Arthur" being the most prominent.

Arthur R. Wyatt
Chairman

Accounting Standards Division

cc: Securities and Exchange Commission

NOTE

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They 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 and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of positions do not establish standards enforceable under the Institute's code of professional ethics.

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.
- 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 prob-

lems 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. 12.

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 noncontrolling 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.¹ 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. The tax liabilities applicable to partnership interests relate directly to the partners, and the accounting for income taxes generally contemplated by APB Opinion 11 is appropriate. Thus, the differences, if any, between income or loss recorded by a partner under the equity method and the partner's share of distributable taxable income or loss from the partnership should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

.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

¹ Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph .11.

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. Also, differences between income or losses recognized for financial reporting purposes and the investor's share of taxable income or losses should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

.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 accord-

ance 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 partnership 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 Changes in Financial Position

.13 APB Opinion 19, which governs the form and content of statements of changes in financial position, requires disclosure of working capital or cash provided from operations. The investor's share of a real estate venture's earnings reported under the equity method, to the extent that such earnings are not distributed in the period earned, should not be included in the amount reported as working capital or cash provided by operations, except to the extent distributions should be accrued as a current receivable under generally accepted accounting principles.

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.² 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 investments, 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.³ 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

² 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 though the underlying profitable pattern of an investee is unimpaired.

³ This recommendation does not apply for real property jointly owned and operated as undivided interests in assets if the claims or liens of the investor's creditors are limited to the investors' respective interests in such property.

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 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.⁴ 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, including loans and advances, other than a temporary decline should be recognized under the accounting principles that apply to a loss in value of long-term assets. 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.

**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

⁴ 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.

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**, 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 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

* 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.

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* *. 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.

.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.

* 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.

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 Pending completion of the Financial Accounting Standards Board's interest project, the division makes no recommendation on accounting for interest income from loans or advances to a real estate venture by an investor that capitalizes interest on its own real estate and development projects.

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

* 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.

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 Subject to the provisions of paragraph .39, an investor should recognize a gain or loss on a sale of its investment in a real estate venture equal to the difference at the time of sale between the selling price and the investor's carrying amount of the portion of the investment sold. Deferred taxes related to timing differences should be recognized.

TRANSITION

.41 The division recommends applying this statement of position to financial statements issued for fiscal years and interim periods beginning after December 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.

* 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.

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➡ *The next page is 18,581.* ←

Section 10,250

Statement of Position 78-10 Accounting Principles and Reporting Practices for Certain Nonprofit Organizations

December 31, 1978

[A Proposed Recommendation to the Financial Accounting Standards Board]

NOTE

Statements of position of the AICPA accounting standards division are issued for the general information of those interested in the subject. They 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 and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

INTRODUCTION

.001 The American Institute of Certified Public Accountants has issued the following industry audit guides applicable to certain types of nonprofit organizations.*

- *Hospital Audit Guide* (1972)
- *Audits of Colleges and Universities* (1973)
- *Audits of Voluntary Health and Welfare Organizations* (1974)
- *Audits of State and Local Governmental Units* (1974)

* In 1981, the AICPA issued Audit and Accounting Guide, *Audits of Certain Non-profit Organizations*.

.002 However, many nonprofit organizations are not covered by any of those guides. This statement of position is issued to recommend financial accounting principles and reporting practices for nonprofit organizations not covered by existing guides that prepare financial statements in conformity with generally accepted accounting principles. This statement is not intended to supersede or amend any of the listed guides. For numerous nonprofit organizations, complex accounting may be neither practical nor economical, and reporting based on cash receipts and disbursements or some other basis may be adequately informative. Under those circumstances, special-purpose financial reports should be prepared.

.003 The provisions of this statement need not be applied to immaterial items.

.004 A number of terms with specialized meanings are used throughout this statement and are defined in Appendix A.

.005 This statement of position applies to all nonprofit organizations not covered by the AICPA industry audit guides listed in paragraph .001, other than those types of entities that operate essentially as commercial businesses for the direct economic benefit of members or stockholders. Examples of the latter category are employee benefit and pension plans, mutual insurance companies, mutual banks, trusts, and farm cooperatives. Although this list is not all-inclusive, the following organizations are among those covered by this statement:

- Cemetery organizations
- Civic organizations
- Fraternal organizations
- Labor unions
- Libraries
- Museums
- Other cultural institutions
- Performing arts organizations
- Political parties
- Private and community foundations
- Private elementary and secondary schools
- Professional associations
- Public broadcasting stations
- Religious organizations
- Research and scientific organizations

Social and country clubs
Trade associations
Zoological and botanical societies

.006 This statement of position applies to many diverse organizations. Some believe that separate accounting guidelines should be issued that fit the special requirements of each type of organization. Others, however, have criticized the published guides and this statement of position because of inconsistencies among the guides, contending that many of the inconsistencies cannot be justified. The accounting standards division believes that continuing to publish separate accounting papers or guidelines for different types of organizations would proliferate accounting practices unnecessarily. Similar transactions generally should be treated similarly by all organizations. The accounting standards division believes that it has considered the principal special requirements or conditions of the organizations covered by this statement of position and has provided special rules or exceptions where deemed appropriate.

.007 Some have contended that the division has not sufficiently considered the costs and efforts involved in implementing its recommendations—especially for smaller organizations. Some organizations may believe that special-purpose reports prepared on a basis other than generally accepted accounting principles better serve their needs—especially in light of the relationship between costs and benefits; these recommendations do not preclude such organizations from continuing to use appropriate special-purpose reports.

USERS OF FINANCIAL STATEMENTS

.008 A wide variety of persons and groups are interested in the financial statements of nonprofit organizations. Among the principal groups are (a) contributors to the organization, (b) beneficiaries of the organization, (c) the organization's trustees or directors, (d) employees of the organization, (e) governmental units, (f) the organization's creditors and potential creditors, and (g) constituent organizations.

.009 A principal purpose of a nonprofit organization's financial statements is to communicate the ways resources have been used to carry out the organization's objectives. It requires reporting the nature and amount of available resources, the uses made of the resources, and the net change in fund balances

during the period. In addition, while adequate measures of program accomplishment generally are not available in the context of present financial statements, the financial statements should identify the organization's principal programs and their costs. A third aspect of financial reporting for nonprofit organizations is disclosure of the degree of control exercised by donors over use of resources. A fourth aspect is that the financial statements of a nonprofit organization should help the reader evaluate the organization's ability to carry out its fiscal objectives.

.010 The division has prepared this statement of position based on the foregoing concepts as a guide to preparing financial statements to be used primarily by persons outside the management of the organization. It recognizes that financial statements prepared for use by management or members of the governing board often require more detail than is prescribed in this statement.

ACCRUAL BASIS OF ACCOUNTING

.011 The accrual basis of accounting is widely accepted as providing a more appropriate record of all an entity's transactions over a given period of time than the cash basis of accounting. The cash basis or any basis of accounting other than the accrual basis does not result in a presentation of financial information in conformity with generally accepted accounting principles. Accordingly, financial statements of nonprofit organizations represented as being in conformity with generally accepted accounting principles should be prepared using the accrual basis of accounting.¹

.012 For example, under accrual basis accounting, goods and services purchased should be recorded as assets or expenses at the time the liabilities arise, which is normally when title to the goods passes or when the services are received. Encumbrances representing outstanding purchase orders and other commitments for materials or services not yet received are not liabilities as of the reporting date and should not be reported as expenses nor included in liabilities on the balance sheet. However, significant commitments should be disclosed in the notes to the financial statements, and an organization may designate in its balance sheet the portion of the fund balance so committed.

¹ Some organizations keep their books on a cash basis throughout the period and, through adjustment at the end of the period, prepare statements on the accrual basis. The requirement is only that the financial statements be presented on the accrual basis and not that the books be kept on that basis throughout the period.

.013 For numerous nonprofit organizations, complex accounting procedures may be neither practical nor economical, and reporting based essentially on cash receipts and disbursements may be adequately informative. If financial statements prepared on the cash basis are not materially different from those prepared on the accrual basis, the independent auditor may still be able to conclude that the statements are presented in conformity with generally accepted accounting principles. Otherwise, cash basis financial statements should be considered to be special purpose financial statements and should be reported on accordingly.

FUND ACCOUNTING

.014 Many nonprofit organizations receive resources restricted for particular purposes. To facilitate observance of limitations, the accounts are often maintained using fund accounting, by which resources are classified for accounting and reporting purposes into funds associated with specified activities or objectives. Each fund is a separate accounting entity with a self-balancing set of accounts for recording assets, liabilities, fund balance, and changes in the fund balance. Although separate accounts are maintained for each fund, the usual practice in preparing financial statements is to group funds that have similar characteristics.

.015 The division believes that reporting on a fund accounting basis may be helpful where needed to segregate unrestricted from restricted resources. If an organization has restricted resources and elects not to report on a fund accounting basis, the financial statements should disclose all material restrictions and observe the specific requirements indicated in paragraphs .016 through .041, "Basic Financial Statements."

BASIC FINANCIAL STATEMENTS

.016 The basic financial statements, including related notes, of nonprofit organizations covered by this statement are—

- Balance sheet
- Statement of activity
- Statement of changes in financial position

.017 The balance sheet is intended to present financial position. The statement of activity, including changes in fund bal-

ances, is intended to present results of operations. However, when it is intended that the financial statements present both financial position and results of operations, all three statements listed in paragraph .016 should be presented.

.018 Although the division has identified the basic financial statements to be prepared, for the most part, it does not prescribe specific titles or formats. Each organization should develop the statement formats most appropriate to its needs in conformity with the principles discussed in this statement. A number of illustrative financial statements are presented in Appendix C to demonstrate the diversity of formats that can be used.

Balance Sheet

.019 The balance sheet should summarize the assets, liabilities, and fund balances of the organization.

.020 An organization's unrestricted fund balance represents the net amount of resources available without restriction for carrying out the organization's objectives. Those resources include amounts designated by the board for specific purposes, undesignated amounts, and, frequently, amounts invested in operating plant. While the balance sheet may set forth amounts designated for a program or other purposes, the total of all unrestricted fund balances, other than amounts shown in a plant fund, as discussed in paragraph .022, should be shown and labeled on the balance sheet.

.021 Current restricted resources and resources restricted for future acquisition of fixed assets should be reported in the balance sheet as deferred revenue until the restrictions are met. Other restricted resources such as endowment funds should be reflected separately in the fund balance section of the balance sheet. If significant, the nature of the restrictions on fund balances and deferred revenues should be described in the notes to the financial statements.

.022 Many organizations use a separate fund to account for the investments in operating plant, art collections, rare books and manuscripts, and similar items. The sources of the funds used to acquire those assets often are a combination of unrestricted and restricted funds. It may not be clear whether assets purchased with restricted funds continue to bear the original donor restrictions. While the division believes an organization should indicate whether the fund balances are restricted or un-

restricted, that may not be possible for the plant fund. Thus, the plant fund may be reported separately or combined with either the unrestricted or restricted funds, as appropriate.

.023 Many organizations covered by this statement have only unrestricted funds. Those organizations should classify their assets as current, fixed, and other long-term assets and should classify their liabilities as current and long-term. To be classified as “current,” the assets generally should be realizable and the liabilities payable within a normal operating cycle; however, if there is no normal operating cycle or the operating cycle is less than one year, all assets expected to be converted to cash or other liquid resources within one year and all liabilities to be liquidated within one year should be classified as current.

.024 Other organizations have both unrestricted and restricted funds. Frequently, the fund classifications themselves adequately disclose the current and long-term nature of the assets and liabilities. If not, a classified balance sheet should be presented.

Statement of Activity

.025 Throughout this statement of position the term *statement of activity* identifies the financial statement that reports the support, revenue, capital or nonexpendable additions, and functional expense categories. The statement might carry a different title, such as *statement of support, revenue, expense, capital additions, and changes in fund balances*, or simply *statement of changes in fund balances*. The statement of activity should include the activity for the period and a reconciliation between the beginning and ending fund balances. However, an organization may prepare two separate statements: a statement of activity and a statement of changes in fund balances. Changes in fund balances should include the excess or deficiency of revenue and support over expenses after capital additions for the period, adjustments to reflect changes in the carrying amount of certain marketable securities and other investments, as discussed in paragraph .080, and the additions and deductions of interfund transfers.

.026 The division has considered the diverse practices used to report details of financial activity. It has concluded that variations in format and presentation are appropriate, provided that the statement of activity shows the major sources and amounts

of revenue and support, as well as the principal sources and amounts of additions to plant, endowment, and other capital funds. This does not prohibit an organization from reporting revenue and expenses separately from sources of support in its financial statements.

.027 Nonprofit organizations derive revenues from a variety of sources—dues, sale of services, ticket sales, investment income, and so forth—but they are often not sufficient to cover the cost of providing services. Many organizations, therefore, solicit support to enable them to fulfill their program objectives. Such support may be obtained from individuals, foundations, corporations, governmental units, and other entities.

.028 Certain contributions cannot be spent currently for program or supporting services because of donor or legal restrictions and have many of the characteristics of “capital.” Such items include gifts, grants, and bequests to endowment, plant, and loan funds restricted either permanently or for a period of time by parties outside the organization. Those items also include investment income that has been restricted by donors and gains or losses on investments held in such funds that must be added to the principal.² The accounting standards division has concluded that disclosure of those items would be useful, and they should be differentiated from items that are available for current operations. Captions such as “capital additions,” or “nonexpendable additions,” should be used.

.029 Capital additions do not include restricted gifts, grants, bequests, or gains on the sale of assets that can be used for current activities even though the contributions have been deferred until the organization incurs an expense that satisfies the terms of the restriction, nor do they include unrestricted amounts that the board designates as nonexpendable. See paragraphs .054 through .062 for a further discussion on current restricted gifts, grants, bequests, and other income.

.030 While there is wide diversity of practice, the division concluded that an “excess” line-item caption in the statement of activity is useful. Although the purpose of the organizations covered by this statement is not to make “profits” as this term is generally used, nonprofit entities can survive only if they have support, revenue, and other additions equal to or in excess

² The division does not suggest that gains on the sales of restricted assets are legally restricted or that they cannot be used at the discretion of the organization. Those are legal questions that depend on applicable law, donor intent, or both

of expenses. This measure is an important indicator of financial health and is therefore of interest to management, members of the governing board, donors, beneficiaries, and other users of the financial statements. Accordingly, the statement of activity should report the excess (deficiency) of revenues and support over expenses for the period.

.031 If financial activities include capital additions, there should be *two* clearly labeled “excess” line-item captions, such as “excess (deficiency) of revenue and support over expenses before capital additions” and “excess (deficiency) of revenue and support over expenses after capital additions” (alternative wording may be used).

Statement of Changes in Financial Position

.032 The statement of changes in financial position provides a summary of available resources and their use during the period.

.033 Many nonprofit organizations obtain their resources from contributions, borrowed money, investment income, and so forth. The statement of changes in financial position provides the user with information about both the methods of financing programs and activities and the use and investment of resources during the period.

.034 The statement of changes in financial position should summarize all changes in financial position, including capital additions, changes in deferred support and revenue, and financing and investing activities.

Other Types of Fund Classifications

.035 Rather than using the traditional fund accounting classifications, some organizations prefer using classifications such as expendable and nonexpendable or unrestricted and restricted in their financial statements. Such classifications are appropriate provided that all the required disclosures indicated in paragraphs .016 through .041 are met.

Columnar v. Layered Presentation

.036 The practice of presenting data by major fund groups has evolved to emphasize meaningful distinctions between the types of unrestricted and restricted resources for which an organization is accountable. Many organizations report finan-

cial position and results of activities in a multicolumn format. Others report their financial statements in a layered or "pancake" format, and still others report certain data in a columnar format and other data in a layered format. Each organization should develop the statement format most appropriate to its needs to conform with the principles discussed in this statement of position.

Totals of All Funds

.037 Some organizations present their financial statements (either in columnar or layered format) only by major fund groups without showing totals of all funds. They do not consider totals of all funds to be meaningful and sometimes consider such totals to be misleading because of restrictions on the use of certain resources; however, other organizations, believing that totals are meaningful, present details by major fund groups and totals of all funds in one or more of their statements.

.038 Certain organizations present financial statements showing only the totals of all funds and do not show the major fund groups. Organizations do that if they do not establish separate funds for reporting purposes, if the financial information concerning particular funds is not significant, or if such information can be adequately set forth in other ways in the statements or the notes.

.039 Financial statements in columnar format lend themselves to presenting totals of all funds. Financial statements presented in layered format lend themselves to fund group presentations with comparative data for the preceding period.

.040 The presentation of totals of all fund groups in all financial statements is preferable, although not required. In presenting such totals, the specifics of the major fund groups should also be provided, and care should be taken to assure that the captions are not misleading and that adequate information is provided concerning interfund borrowings and important restrictions on the uses of resources.

Comparative Financial Statements

.041 Although it is not required, financial statements of the current period should be presented on a comparative basis with financial statements for one or more prior reporting periods. If multi-column financial statements are presented for the current period, some organizations prefer to present only sum-

marized, total-all-funds information (in a single column) for each of the prior periods because of space limitations and to avoid the confusion that a second set of multi-column statements might cause. However, where it is intended to present financial statements of the prior periods as well as the current period in accordance with generally accepted accounting principles, care must be taken that there is sufficient disclosure in the summarized data and in the supporting notes.

FINANCIALLY INTERRELATED ORGANIZATIONS

.042 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.

.043 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.

.044 Nevertheless, the division has concluded that combined financial statements are necessary for informative presentation of certain financially interrelated organizations. To balance these objectives, combined financial statements should be presented if (1) control exists as defined in paragraph .042 and (2) any of the following circumstances exists:

- a. Separate entities solicit funds in the name of and with the expressed or implicit 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.

The basis for combining financial statements, including the interrelationship of the combined organizations, should be disclosed in the notes to the financial statements.

.045 Legally unrestricted resources held by organizations related to the reporting organization may be effectively restricted with respect to the reporting organization. In combined financial statements that include both the related organization and the reporting organization, it may be appropriate to present all resources of the related organization, both unrestricted and restricted, as restricted resources.

.046 A national or international organization may have state or local chapters with varying degrees of autonomy. Affiliated organizations may be separate corporate entities or unincorporated boards, committees, or chapters. It is not intended to require a national or "parent" organization with loosely affiliated local organizations whose resources are principally derived and expended locally to combine the local organizations' financial statements with its own. The loose affiliation of the local organization would be characterized by locally determined program activities, financial independence of the local organization, and local organization control of its assets. Therefore, combined financial statements need not be presented unless the financial relationships between the entities are as described in paragraph .044.

.047 If affiliated organizations are not combined because they do not meet the combining criteria or have loosely affiliated local organizations, the existence of the affiliates and their relationships to the reporting organization should be disclosed.

.048 In view of the unique and complex organizational relationships and degrees of local autonomy common in religious organizations, there may be many circumstances in which application of this section on combination would not result in meaningful financial information. Thus, if a religious organization concludes that meaningful financial information would not result from the presentation of combined financial statements, the provisions of this section need not be applied.

Related-Party Transactions

.049 Contributions made to an organization by its governing board members, officers, or employees need not be separately disclosed if the contributors receive no reciprocal economic benefits.

REVENUE, SUPPORT, AND CAPITAL ADDITIONS

.050 The statement of activity should report revenue, support, and capital additions. Revenue and support are discussed under "Statement of Activity," paragraphs .025 through .031.

Capital Additions

.051 Capital additions include nonexpendable gifts, grants, and bequests restricted by donors to endowment, plant, or loan funds either permanently or for extended periods of time. Capital additions also include legally restricted investment income and gains or losses on investments held in such funds that must be added to the principal.³ Capital additions do not include donor-restricted gifts for program or supporting services.

.052 Capital additions that are restricted for acquisition of plant assets should be treated as deferred capital support in the balance sheet until they are used for the indicated purpose. Once used, these amounts should be reported as capital additions in the statement of activity.

.053 Some organizations may prefer to use the caption "non-expendable additions" instead of "capital additions." As previously noted, that or other wording is acceptable.

Current Restricted Gifts, Grants, Bequests, and Other Income

.054 Current restricted gifts, grants, bequests, and other income provide expendable resources that have been restricted by donors, grantors, or other outside parties to the purposes for which they may be used. Such restrictions usually involve written assertions expressed in restrictive language by one party to the other. Amounts received from appeals for restricted funds by solicitation letter, radio, television, newspaper, and so forth are generally deemed to be restricted according to the nature of the appeal.

³ See footnote 2.

.055 Two alternative accounting conventions have been used for reporting current restricted resources. Some report the full amount of such resources when received as “revenue and support” in a current restricted fund column in the statement of activity, without regard to whether the resources were used or the restrictions met.⁴ Unspent amounts are reported in the “excess (deficiency) of revenue and support over expenses” and included in the fund balance of the current restricted fund.

.056 This accounting convention is used because restricted resources are available for current use regardless of whether they are spent, and full accountability requires that this be recognized by reflecting receipt of such resources as revenue and support. Those who disagree express concern that the recognition of such amounts as revenue and support overlooks the legal obligation to return the resources if they are not used for the restricted purpose. They further contend that large amounts received near the end of the period may significantly distort the financial statements of the organization.

.057 The other accounting convention has been based on an assumption that a donee organization should not recognize such amounts as revenue until the particular resources are used for the purpose specified by the donors, since they are not “earned” until they are used and the restrictions met.⁵ Under this accounting convention, receipts of current restricted funds are not reported as revenue until the resources are expended for the purpose specified. Until then, they are reported as a direct addition to the fund balance of the current restricted fund.

.058 This approach may be satisfactory for restricted grants that impose conditions of discrete accountability with the requirement that unspent balances be refunded to the grantors. However, it allows management to defer recognition of restricted support as revenues although applicable expenses have been incurred.

.059 The accounting standards division believes that neither accounting convention is entirely satisfactory and that the conventions should be changed based on the following concepts:

- a. The recognition of the receipt of restricted funds as revenues should be determined by economic events rather than by

⁴This is the approach recommended by the AICPA industry audit guide, *Audits of Voluntary Health and Welfare Organizations* (New York: AICPA, 1974)

⁵This is the approach recommended by the AICPA industry audit guides for hospitals and for colleges and universities.

arbitrary management decisions. The same economic events affecting two similar organizations in a similar manner should not appear to produce two different results because of differences in the management objectives.

- b. For accounting purposes, donor restrictions are complied with when the organization incurs an expense for the function, program, project, or object and in the manner specified in the donative instrument or grant award unless such expense is attributable to other restricted funds.
- c. Unexpended restricted funds should be reported in a manner that reflects the restrictions attached to such funds.

.060 For example, if a donor restricted a contribution or responded to an appeal for restricted contributions to be used for a specific program service and the organization subsequently, or in anticipation of receiving the restricted contributions, incurred expenses for that particular program service, the accounting standards division believes the obligation imposed by the restriction should be deemed to have been met even if unrestricted funds were used. Management should not avoid recognizing the restricted contribution as support in that period simply because it chose to use dollars attributed to unrestricted funds at the time the expense was incurred.

.061 Unless the donor specifies to the contrary, the donee organization should consider only expenses incurred after the receipt of the restricted contribution as meeting the restriction. This does not apply if the donor or grantor contributes in response to an appeal that specifies that the related expenses may have already been incurred in whole or in part.

.062 The division has concluded, therefore, that current restricted gifts, grants, bequests, and other income should be accounted for as revenue and support in the statement of activity to the extent that expenses have been incurred for the purpose specified by the donor or grantor during the period. The balances should be accounted for as deferred revenue or support in the balance sheet outside the fund balance section until the restrictions are met. The specific language in the donative instrument or grant award should govern whether restrictions have been met. Recognition of expenses that satisfy donor restrictions results in recognition of equivalent amounts of revenue or support in that period.

Unrestricted Gifts, Grants, and Bequests

.063 Unrestricted gifts, grants, and bequests should be reported in the unrestricted fund in the statement of activity above the caption "excess (deficiency) of revenue and support over expenses before capital additions."

Pledges

.064 Pledges an organization can legally enforce should be recorded as assets and reported at their estimated realizable values. In determining these values, such matters as the donee organization's past collection experience, the credit standing of the donor, and other matters affecting the collectibility of the pledges should be considered.

.065 The estimated realizable amount of pledges should be recognized as support in the period designated by the donor. If the period designated by the donor extends beyond the balance sheet date, the pledge should be accounted for as deferred support in the balance sheet. In the absence of a specified support period, the net estimated realizable amount of pledges scheduled to be received over a future period should be assumed to be support for that period and should be accounted for as deferred support in the balance sheet.

.066 Pledges for fixed assets should also be recorded in the balance sheet at their estimated realizable values and reported in the statement of activity as provided in paragraph .052.

Donated and Contributed Services

.067 The nature and extent of donated or contributed services received by organizations vary and range from the limited participation of many individuals in fund-raising activities to active participation in the organization's service program. Because it is difficult to place a monetary value on such services, their values are usually not recorded. The accounting standards division believes that those services should not be recorded as an expense, with an equivalent amount recorded as contributions or support, unless all of the following circumstances exist:

- a. The services performed are significant and form an integral part of the efforts of the organization as it is presently constituted; the services would be performed by salaried personnel if donated or contributed services were not available for

the organization to accomplish its purpose; and the organization would continue this program or activity.

- b.* The organization controls the employment and duties of the service donors. The organization is able to influence their activities in a way comparable to the control it would exercise over employees with similar responsibilities. This includes control over time, location, nature, and performance of donated or contributed services.
- c.* The organization has a clearly measurable basis for the amount to be recorded.
- d.* The services of the reporting organization are not principally intended for the benefit of its members. Accordingly, donated and contributed services would not normally be recorded by organizations such as religious communities, professional and trade associations, labor unions, political parties, fraternal organizations, and social and country clubs.

.068 Participation of volunteers in philanthropic activities generally does not meet the foregoing criteria because there is no effective employer-employee relationship. (See criterion *b*, above.)

.069 Services that generally are not recorded as contributions, even though the services may constitute a significant factor in the operation of the organization, include the following:

- a.* Supplementary efforts of volunteer workers that are provided directly to beneficiaries of the organization. Such activities usually involve auxiliary activities or other services that would not otherwise be provided by the organization as a part of its operating program.
- b.* Periodic services of volunteers in concentrated fund-raising drives. The activities of volunteer solicitors are not usually subject to a degree of operating supervision and control by the organization sufficient to provide a basis for measuring and recording the value of time devoted. However, if individuals perform administrative functions in positions that would otherwise be held by salaried personnel, consideration should be given to recording the value of those services.

.070 Notes to the financial statements should disclose the methods used by the organization in valuing, recording, and reporting donated or contributed services and should distinguish

between donated or contributed services for which values have and have not been recorded.

Donated Materials and Facilities

.071 Donated material and facilities, if significant in amount, should be recorded at their fair value, provided the organization has a clearly measurable and objective basis for determining the value. If the materials are such that values cannot reasonably be determined, such as clothing, furniture, and so forth, which vary greatly in value depending on condition and style, they should not be recorded as contributions. If donated materials pass through the organization to its charitable beneficiaries, and the organization serves only as an agent for the donors, the donation should not be recorded as a contribution. The recorded value of the use of contributed facilities should be included as revenue and expense during the period of use.

Investment Income and Gains and Losses

.072 Unrestricted investment income (interest and dividends) from all funds should be reported as revenue in the statement of activity when it is earned. All unrestricted gains and losses on investments of unrestricted and current restricted funds should also be reported in the statement of activity before the excess (deficiency) of revenue and support over expenses before capital additions. See paragraphs .077 through .082 for a discussion of the carrying amount of investments and the bases of reporting gains and losses.

.073 As discussed in paragraph .021, restricted investment income and restricted gains and losses from investments of current restricted funds and restricted plant funds should be reported as deferred amounts in the balance sheet. Restricted expendable income from investments of endowment funds should also be reported as deferred amounts. Income from investments of endowment funds that must be added to the principal by direction of the donor should be reported as capital additions. Gains and losses on investments of endowment funds should be reported as capital additions or deductions.

.074 Traditionally, nonprofit organizations have accounted for income yield (dividends, interest, rents, royalties, and so forth) as revenues available for current purposes and have excluded from that category capital gains on investment transactions of the endowment fund.

.075 In recent years, some institutions have adopted what is usually referred to as a “total return” approach to the management of investments of endowment and quasi-endowment funds. This investment approach emphasizes total investment return consisting of traditional yield plus or minus gains and losses. Typically, the governing board establishes a “spending rate” that is satisfied by traditional yield first, that is, by dividends and interest. To the extent that traditional yield is inadequate to meet the spending rate, the governing board may make a portion of realized, and in some cases unrealized, net gains available for current use. The use of net gains on investments of true endowment funds by the governing board is usually done with the advice of legal counsel.

.076 A problem arises in the method of accounting for the available net gains from endowment funds because the concept thus far has produced few, if any, applications that appear to be objectively determinable. For example, some institutions have reported net gains made available as revenues, while most others follow existing AICPA industry audit guides and account for this transaction as a transfer from endowment funds to other funds. In some situations when traditional yield has exceeded the spending rate, the excess has been added directly to endowment fund balances rather than being reported as revenue. The spending rate policies of many institutions tend to place primary emphasis on spending without regard to the effect on endowment fund principal. While all of the total return approaches emphasize the use of prudence and a rational and systematic formula, those matters are subjective and not susceptible to measurement. Consequently, the accounting standards division concludes that the portion of available net gains from endowment investments utilized should be reported in the statement of activity as a transfer from endowment funds to other funds. To the extent such gains are transferred to a restricted fund in which unexpended gifts and investment income are reported as deferred support and revenues, the gains should be transferred to deferred revenue of that fund. Since quasi-endowment funds are to be accounted for as a part of current funds, using net gains on the investments of these funds does not involve a transfer. Such gains and losses should be accounted for in the manner specified in paragraph .072.

Carrying Amount of Investments

.077 Nonprofit organizations have traditionally carried purchased investments at cost and donated investments at fair value at date of receipt. Investments have normally been written down to market value when market values have declined below the carrying value and the declines were deemed to be permanent impairments. Beginning in 1973 with the issuance of the AICPA industry audit guide for colleges and universities, some nonprofit organizations have been carrying their investments at market, as a permissible alternative to cost, adjusting the carrying amount each year for value increases and decreases.

.078 An organization carrying investments at market value recognizes the gains or losses that result from market fluctuations for the period in which the fluctuations occur. Those who are against carrying investments at market are concerned both with the difficulty of valuing nonmarketable investments and the effect that market fluctuations have on an organization's results of activity as reflected in the financial statements.

.079 The division has concluded that organizations covered by this statement of position should report investments in the financial statements as follows:

- Marketable debt securities, when there is both the ability and intention to hold the securities to maturity, should be reported at amortized cost, market value, or the lower of amortized cost or market value;
- Marketable equity securities and marketable debt securities that are not expected to be held to maturity should be reported at either market value or the lower of cost or market value;
- Other types of investments, for example, real estate or oil and gas interests, should be reported at either fair value or the lower of cost or fair value.

The basis selected to value each of these three groups of investments should apply to all investments in that group. When investments are carried at other than market value, disclosure of market value for that group at the balance sheet date should be made.

.080 For investments carried at the lower of (amortized) cost or market value, the division believes that declines should be recognized when the aggregate market value by fund group is less than the carrying amount. Recoveries of aggregate

market amount in subsequent periods should be recorded in those periods subject only to the limitation that the carrying amount should not exceed the original cost. The adjustments to recognize the increases or decreases resulting from the application of this paragraph for noncurrent investments should be recognized as a direct addition or deduction to the fund balance; the adjustments applicable to current investments should be reflected in the statement of activity in the same manner as realized gains and losses. Investments held in current restricted funds should normally be considered to be current investments for purposes of this paragraph.

.081 For investments carried at market value, increases or decreases in market value should be recognized in the period in which they occur, as described in paragraphs .072 and .073.

.082 Interfund sales or exchanges of investments that involve a restricted fund should be recorded in the purchasing fund at fair value. The difference between the carrying amount and the fair value at the date of the sale or exchange should be accounted for in the selling fund in the same manner as realized gains and losses and appropriately disclosed.

.083 The notes to the financial statements should set forth a summary of the total realized and unrealized gains and losses and income derived during the fiscal period from investments held by all funds except life income and custodial funds.

Subscription and Membership Income

.084 Subscriptions and revenues derived from the performance of services or the sale of goods should be recognized as revenue in the periods in which they are provided. Revenue derived from membership dues should be recognized by the organization over the period to which the dues relate. Non-refundable initiation and life membership fees should be recognized as revenue in the period the fees are receivable, if future dues or fees can reasonably be expected to cover the cost of future services; otherwise, the fees should be amortized to future periods based on average membership duration, life expectancy, or other appropriate methods. However, if items such as dues, assessments, and nonrefundable initiation fees are in substance contributions and services are not to be provided to the member, they should be recognized as revenue and support in the periods in which the organization is entitled to them.

EXPENSES

Functional Classification of Expenses

.085 Organizations that receive significant support in the form of contributions from the general public should summarize the cost of providing various services or other activities on a functional basis in the statement of activity. (For purposes of this paragraph, the accounting standards division believes that organizations receiving support from federated fund-raising or similar organizations are deemed to have received support from the general public.) Organizations receiving no significant support from such contributors are encouraged to report on a functional basis but may choose to summarize expenses on another basis (such as natural classifications) that would be considered useful to readers of the statement of activity. If expenses are not reported on a functional basis, the notes should contain a description of the basic programs of the organization. The remainder of this section is for those organizations that report expenses on a functional basis.

.086 The functional classifications should include specific program services that describe the organization's service activities and supporting services, such as management and general and fund-raising.

.087 The statement of activity should present costs separately for each significant program and supporting activity. Program activities are those directly related to the purposes for which the organization exists. Supporting activities do not relate directly to the purposes for which the organization exists. Fund raising, membership development, and unallocated management and general expense are three examples of supporting activities that should be reported separately.

.088 An organization may also present as supplementary information a schedule of functional expenses by object classification, that is, classifying expenses by type rather than function, such as salaries, employee-benefit expenses, and purchased services.

Program Services

.089 Functional reporting classifications for program services vary according to the nature of the service rendered. For some organizations, a single functional reporting classification may be adequate to portray the program service provided. In

most cases, however, several separate and identifiable services are provided, and in such cases, expenses for program services should be reported by the type of service function or group of functions. The purposes of the various functions should be clearly described, and each functional classification should include all of the applicable service costs.

.090 Some local organizations remit a portion of their receipts to an affiliated state or national organization. The amount to be paid to the affiliates should be reported as either an expense or a deduction from total support and revenue in the statement of activity. The appropriate treatment depends on the arrangements: A reporting organization that is, in effect, a collecting agent for the state or national organization, such as local organizations that are required to remit a fixed percentage of all contributions, should report the remittance as a deduction from total support and revenue; other organizations should report the remittance as a program expense.

Management and General Costs

.091 Management and general costs are those not identifiable with a single program or fund-raising activity but are indispensable to the conduct of those activities and to an organization's existence, including expenses for the overall direction of the organization's general board activities, business management, general recordkeeping, budgeting, and related purposes. Costs of overall direction usually include the salary and expenses of the chief officer of the organization and his staff. However, if such staff spend a portion of their time directly supervising program services or categories of supporting services, their salaries and expenses should be prorated among those functions. The costs of disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, the annual report, and so forth, should likewise be classified as management and general expenses.

Fund-Raising and Other Supporting Services

.092 Fund-raising costs are incurred in inducing others to contribute money, securities, time, materials, or facilities for which the contributor will receive no direct economic benefit. They normally include the costs of personnel, occupancy, maintaining mailing lists, printing, mailing, and all direct and indirect costs of soliciting, as well as the cost of unsolicited

merchandise sent to encourage contributions. The cost of such merchandise should be disclosed. Fund-raising costs paid directly by a contributor should be reported as support and as fund-raising expenses.

.093 Some organizations hold special fund-raising events, such as banquets, dinners, theater parties, and so forth, in which the donor receives a direct benefit (for example, a meal or theater ticket). Some organizations sell merchandise as a fund-raising technique. The costs of such merchandise or direct benefits are not considered fund-raising costs and should be applied against gross proceeds received from the person receiving such direct benefit. The costs of such merchandise or direct benefit costs should be disclosed.

.094 A growing number of users of financial statements are seeking financial information that will enable them to evaluate fund-raising costs. A single functional reporting classification ordinarily is adequate to portray the fund-raising activity; however, other organizations may believe that reporting total public support and total fund-raising expense does not provide adequate information for a useful evaluation because the organizations conduct a number of fund-raising activities with widely varying relationships. For those organizations, it may be appropriate to report fund-raising costs and the corresponding support obtained separately for each type of fund-raising function, either in the statement of activity or in the notes. The various fund-raising functions should be adequately described and should include all of the applicable costs. The total of all fund-raising activities should be disclosed whether the entity reports expenses on a functional or some other basis.

.095 Fund-raising efforts made in one year, such as those made to obtain bequests or to compile a mailing list of prospective contributors, often result in contributions that will be received in future years. Some have advocated deferring the costs of such fund-raising efforts until the period in which the contributions are expected to be received. Although there may be valid reasons to consider deferring those costs, the accounting standards division is concerned with the difficulty of assessing their ultimate recovery and the possibility of misstating the fund-raising cost relationships. Accordingly, fund-raising costs should be expensed when incurred. However, if pledges or restricted contributions that have already been received are recorded as deferred revenue and support, related fund-raising costs, if specifically identifiable with the contributions, may also

be deferred if it is clear that the contributor intended that the contribution could be used to cover such costs. Similarly, costs incurred in the acquisition of literature, materials, and so forth, that will be used in connection with a fund-raising drive to be conducted in a succeeding period should be deferred to that period.

.096 Costs incurred in the solicitation of grants from foundations or governments and cost of membership development in bona fide membership organizations should be shown as separate categories of supporting expenses. If the membership fee includes an element of contribution, the costs of membership development should be allocated between membership development and fund raising.

.097 If an organization combines the fund-raising function with a program function (for example, a piece of educational literature with a request for funds), the costs should be allocated to the program and fund-raising categories on the basis of the use made of the literature, as determined from its content, the reasons for its distribution, and the audience to whom it is addressed.

Allocation of Costs That Pertain to Various Functions

.098 In some larger organizations, individual functions are performed by separate departments, with expenses classified by types within each department. Many other organizations incur items of cost that apply to more than one functional purpose. For those organizations, it may be necessary to allocate the costs among functions. Examples include salaries of persons who perform more than one type of service, rental of a building used for various program services, management and general expenses, and expenses of fund-raising activities.

.099 The salaries of employees who perform duties relating to more than one function, as well as all other expenses pertaining to more than one function, should be allocated to the separate functional categories according to procedures that determine, as accurately as possible, the portion of the cost related to each function.

.100 A reasonable allocation of an organization's functional expenses may be made on a variety of bases, and costs that have been allocated to programs and supporting services should be disclosed in the notes to the financial statements. It is not

the intention of this statement to require organizations to undertake extensive detailed analyses and computations aimed at making overly meticulous allocations. The division recognizes that meaningful financial statements can often be prepared using estimates and overall computations when appropriate. (See Appendix B for illustrative allocation procedures.)

Grants

.101 Organizations that make grants to others should record grants as expenses and liabilities at the time recipients are entitled to them. That normally occurs when the board approves a specific grant or when the grantee is notified.

.102 Some grants stipulate that payments are to be made over a period of several years. Grants payable in future periods subject only to routine performance requirements by the grantee and not requiring subsequent review and approval for continuance of payment should be recorded as expenses and liabilities when the grants are first made. However, if the grant instrument specifically states that the grantor reserves the right to revoke the grant regardless of the performance of the grantee, unpaid grants should not be recorded. Grants subject to periodic renewal should be recorded as expenses and liabilities at renewal with a disclosure of the remaining commitment in the notes to the financial statements.

Tax Allocation

.103 Certain organizations are subject to a federal excise tax on investment income or to federal and state income taxes on certain unrelated business income. If timing differences exist between the income base for tax and financial reporting purposes, interperiod allocation of tax should be made.

Transfers

.104 Allocations of resources among fund groups are neither revenues nor expenses of the related funds and should be distinguished from support and revenues that increase the total resources available to fulfill the objectives of an organization. Therefore, interfund transfers, including board-designated transfers of gains under the total-return concept, should be reported as changes in fund balances under the caption "fund balance beginning of the period." Transfers required under contractual arrangements with third parties should be separately disclosed. Transfers required as a result of the expiration of a term endowment fund also should be separately disclosed.

BALANCE SHEET

Fixed Assets

.105 Nonprofit organizations should capitalize purchased fixed assets at cost. Donated fixed assets should be recorded at their fair value at the date of the gift. Organizations that have not previously capitalized their fixed assets should do so retroactively. If historical costs are unavailable for assets already in service, another reasonable basis may be used to value the assets. Other bases might be cost-based appraisals, insurance appraisals, replacement costs, or property tax appraisals adjusted for market. However, an alternative basis should be used only if historical cost information is unavailable and only to establish a value at the date an organization adopts this statement of position. Subsequent additions should be recorded at cost, or fair value for donated assets. The basis of valuation and the amount of any assets pledged to secure outside borrowing should be disclosed in the financial statements.

Depreciation

.106 In Accounting Terminology Bulletin no. 1, *Review and Résumé*, the AICPA Committee on Terminology, defined *depreciation accounting* as a means of allocating the cost or other carrying value of tangible capital assets to expense over their useful lives:

Depreciation accounting is a system of accounting 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 (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not valuation. *Depreciation for the year* is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

.107 Exhaustible fixed assets should be depreciated over their estimated useful lives. The relative effort being expended by one organization compared with others and the allocation of the efforts to various programs of the organization are indicated, in part, by cost determinations. Depreciation of fixed assets used in providing such services is relevant as an element of that cost. Although depreciation can be distinguished from most other elements of cost in that it requires no current equivalent cash outlay, recognition of depreciation as a cost is not optional. Most assets used in providing services are both valuable and

exhaustible. Thus, a cost is associated with the use of exhaustible assets whether they are owned or rented, acquired by gift or by purchase or used by a business or a nonprofit organization.

.108 Assets that are not exhaustible, such as landmarks, monuments, cathedrals, or historical treasures, need not be depreciated. Structures used primarily as houses of worship need not be depreciated.

.109 An organization may receive grants, allocations, or reimbursements from other organizations on the basis of the cost associated with its program and supporting services. Recording depreciation as an element of cost does not indicate that it necessarily should be included in the base on which grants, allocations, or reimbursements will be determined: whether the base includes or excludes depreciation depends on the agreement or understanding reached between the two organizations.

.110 The amount of depreciation provided on assets carried at historical cost and the amount, if any, provided on assets carried on a basis other than historical cost should be disclosed.

.111 Depreciation accounting is sometimes confused with funding replacements. The means of replacing fixed assets and the degree to which replacements should be funded currently are financing decisions to be made by the governing board and do not directly affect the current costs of providing program or supporting services. Depreciation accounting is designed to determine and present those costs, not to provide replacement funds.

.112 Retroactive adjustments should be made to reflect accumulated depreciation as of the date an organization adopts this statement of position. For this purpose, the determination of asset lives should be based on a combination of the period from acquisition to the adoption date, plus estimated remaining life based on the current condition and planned use of the assets. When an organization records fixed assets using one of the "current value" methods referred to in paragraph .105, it is not necessary to disclose accumulated depreciation that would have been recorded had cost-based data been available.

Collections

.113 The accounting standards division considered at length the desirability of capitalizing (but not depreciating) the inexhaustible collections owned by museums, art galleries, botanical gardens, libraries, and similar entities. In view of the steward-

ship of those organizations to the public, it is desirable to catalogue and control the collections. Some believe that it is also desirable to present values for the collections on the organizations' balance sheets, since those values usually represent the largest assets of the organizations. The division has concluded that it is often impracticable to determine a value for such collections and accordingly has concluded that they need not be capitalized. If records and values do exist for the collections, the division encourages capitalization, at cost, if purchased, and at a fair value, if acquired by donation. If historical cost is indeterminable, the alternative methods of valuing described in the section on fixed assets should be used. If such collections are not capitalized, the caption "collections" should appear on the balance sheet with no amount shown but with a reference to a note that describes the collections.

.114 The nature and the cost or contributed value of current-period accessions and the nature of and proceeds from deaccessions should be disclosed in the financial statements.

.115 Collections that are exhaustible, such as exhibits with a limited display life, and that have been capitalized should be amortized over their useful lives.

Investment Pools

.116 To obtain investment flexibility, nonprofit organizations frequently pool investments of various funds. Inasmuch as the realized and unrealized gains or losses and income of specific investments cannot be identified with the specific funds participating in the pool, realized and unrealized gains or losses and income should be allocated equitably. To accomplish an equitable allocation, investment pools should be operated using the "market value unit method." Under that method, each fund is assigned a number of units based on the relationship of the market value of all investments at the time of entry in the pool. Periodically, the pooled assets are valued and new unit values are calculated. The new unit value is used to determine the number of units to be allocated to new funds entering the pool or to calculate the equity of funds withdrawing from the pool. Investment pool income, gains, and losses should be allocated periodically to participating funds based on the number of units held by each fund during the period. Other methods based on market value, including percentage participation, may also accomplish the same result.

.117 Pooled investments may include investments carried at other than market value even though, as indicated in paragraph .116, the pool itself must be operated on the basis of market value. Differences may exist between the carrying amounts of assets and fund balances withdrawn from the investment pool. Such differences should be allocated to the participating funds remaining in the pool in the same manner as income, gains, and losses. Alternatively, such adjustments could be reported separately from the carrying amount of specific investments or the fund balances of funds remaining in the pool.

Interfund Borrowings

.118 A governing board may sometimes authorize borrowings from restricted, endowment, or plant funds. The organization should determine if interest should be accrued. Interfund borrowings should be considered permanent and recorded as transfers when it becomes evident that contemplated sources of funds for repayment are not readily available. There may be legal prohibitions against lending such funds and against recording such transfers. If so, appropriate disclosure should be made.

.119 Material interfund borrowings should be disclosed when restricted funds have been loaned or when the liquidity of either fund is in question. If summary financial information is presented for a prior period, similar disclosure should be made.

Designations of Fund Balances

.120 The governing board of an organization may designate a portion of an unrestricted fund balance for a specific purpose. The designation is proper to the board's managerial function. However, such designations of fund balances are not expenses and should not be shown as such in the statement of activity. (See examples of designations in the Illustrative Financial Statements, Appendix C.)

Other Funds

.121 Donors frequently make gifts of future interests. The present value of the actuarially determined liability resulting from an annuity gift should be recorded at the date of the gift. The excess (or deficiency) in the amount of the annuity gift over the liability should be recorded as support in the year of the gift if it may be used immediately for the general purposes of the organization; in other instances, the excess should be reported as deferred revenue if restricted for specific purposes.

The principal amount of life income gifts, in which the donor reserves the right to the income generated from the gift for life or some other stipulated period of time, should also be recorded as deferred support in the balance sheet in the period the gift is received. The amount previously recorded as deferred support should be reflected as support or a capital addition at the future date when the terms of the annuity or life income gifts have been met.

.122 Funds that are held in trust by others under a legal trust instrument created by a donor independently of the reporting organization and that are neither in the possession nor under the control of the organization but are held and administered by outside fiscal agents with the organization deriving income from such funds should not be included in the balance sheet with funds administered by the organization. The funds contemplated by this paragraph are those of which the reporting organization is not the remainderman in the trust. Their existence should be disclosed either parenthetically in the endowment funds group in the balance sheet or in the notes to the financial statements. Significant income from such trusts should be reported separately.

.123 Certain organizations have customarily used other fund groups not specifically mentioned in this statement. Those fund groups are used to account for resources relating to activities such as agency or custodial relationships, self-administered pensions, and permanent maintenance funds. Such fund groups are frequently useful and informative and, therefore, may be reported separately in the financial statements. Alternatively, those funds may be combined with other similar fund groups to simplify statement presentation. In either case, the accountability for the fund group should be classified according to the exact nature of the funds involved, so that balances that are liabilities (such as agency, custodial, and self-administered pension funds) are distinguished from those that are fund balances (such as permanent maintenance funds). If there are true fund balances, changes in the balances should be accounted for in the statement of activity. The restricted nature of such funds should also be disclosed.

TRANSITION

.124 The accounting standards division recognizes that the Financial Accounting Standards Board presently has on its agenda a project on "Objectives of Financial Reporting by Non-

business Organizations.” The results of that project may affect financial reporting by the entities covered by this statement of position. On completion of that project, any recommendations in this statement of position that conflict with the FASB’s conclusions would need to be changed. Accordingly, the division has concluded that the principles contained in this statement of position need not be adopted until after the Financial Accounting Standards Board completes its project. At that time, a specific date on which the adoption of these principles is recommended will be announced. Organizations may voluntarily adopt these principles.

.125 Organizations that adopt the conclusions of this statement of position should apply them retroactively by prior-period adjustments. If financial statements for periods prior to adoption are not presented, the conclusions of the statement of position should be applied by adjusting opening fund balances for the initial application period. When financial statements for periods prior to adoption are presented, they should be restated to reflect the prior-period adjustments. The nature of the restatements and their effects should be disclosed in the period of change.

APPENDIX A

.126 Glossary

A number of terms used throughout this document are commonly used by nonprofit organizations and, because these terms have specialized meaning, this glossary is included.

accessions Additions, both purchased and donated, to collections held by museums, art galleries, botanical gardens, libraries, and similar entities.

agency fund *See* custodian funds.

annuity gift A gift of money or other property given to an organization on the condition that the organization bind itself to make periodic stipulated payments that terminate at a specified time to the donor or other designated individuals.

auxiliary activity An activity providing a service that is not part of the basic program services of the organization. A fee is normally charged that is directly related to, although not necessarily equal to, the cost of the service.

capital additions Gifts, grants, bequests, investment income, and gains and losses on investments restricted either permanently or for a period of time by parties outside of the organi-

zation to endowment and loan funds. Capital additions also include similar resources restricted for fixed asset additions but only to the extent expended during the year.

collections Works of art, botanical and animal specimens, books, and other items held for display or study by museums and similar institutions.

custodian funds Funds received and held by an organization as fiscal agent for others.

deaccessions Dispositions of items in collections held by museums, art galleries, botanical gardens, libraries, and similar entities.

deferred capital additions Capital additions received or recorded before the related restrictions are met. *See also* capital additions.

deferred revenue and support Revenue or support received or recorded before it is earned, that is, before the conditions are met, in whole or in part, for which the revenue or support is received or is to be received.

designated funds Unrestricted funds set aside for specific purposes by action of the governing board. *See also* quasi-endowment funds.

encumbrances Commitments in the form of orders, contracts, and similar items that will become payable when goods are delivered or services rendered.

endowment fund A fund in which a donor has stipulated in the donative instrument that the principal is to be maintained inviolate and in perpetuity and only the income from the investments of the fund may be expended. *See also* term endowment.

expendable funds Funds that are available to finance an organization's program and supporting services, including both unrestricted and restricted amounts.

functional classification A classification of expenses that accumulates expenses according to the purpose for which costs are incurred. The primary functional classifications are program and supporting services.

fund An accounting entity established for the purpose of accounting for resources used for specific activities or objectives in accordance with special regulations, restrictions, or limitations.

fund group A group of funds of similar character, for example, operating funds, endowment funds, and annuity and life income funds.

funds held in trust by others Resources held and administered, at the direction of the donor, by an outside trustee for the benefit of the organization.

investment pool Assets of several funds pooled or consolidated for investment purposes.

life income agreement An agreement whereby money or other property is given to an organization on the condition that the organization bind itself to pay periodically to the donor or other designated individual the income earned by the assets donated to the organization for the lifetime of the donor or of the designated individual.

loan funds Resources restricted for loans. When both principal and interest on the loan funds received by the organization are loanable, they are included in the loan-fund group. If only the income from a fund is loanable, the principal is included in endowment funds, while the cumulative income constitutes the loan fund.

natural expense classification *See* object classification of expenses.

net investment in plant The total carrying value of all property, plant, equipment, and related liabilities, exclusive of those real properties that are held for investment.

nonexpendable additions *See* capital additions.

object classification of expenses A method of classifying expenditures according to their natural classification, such as salaries and wages, employee benefits, supplies, purchased services, and so forth.

pledge A promise to make a contribution to an organization in the amount and form stipulated.

quasi-endowment funds Funds that the governing board of an organization, rather than a donor or other outside agency, has determined are to be retained and invested. The governing board has the right to decide at any time to expend the principal of such funds. *See also* designated funds.

restricted funds Funds whose use is restricted by outside agencies or persons as contrasted with funds over which the organization has complete control and discretion.

revenues Gross increases in assets, gross decreases in liabilities, or a combination of both from delivering or producing goods, rendering services, or other earning activities of an organization during a period, for example, dues, sale of services, ticket sales, fees, interest, dividends, and rent.

support The conveyance of property from one person or organization to another without consideration, for example, donations, gifts, grants, or bequests.

term endowment A fund that has all the characteristics of an endowment fund, except that at some future date or event it will no longer be required to be maintained as an endowment fund.

transfer Moving fund balances from one fund to another, usually as a result of an intended change in the use of assets.

unrestricted funds Funds that have no external restriction on their use or purpose, that is, funds that can be used for any purpose designated by the governing board as distinguished from funds restricted externally for specific purposes (for example, for operations, plant, and endowment).

APPENDIX B

.127 Illustrative Allocation Procedures Under Paragraph .100

Although the following allocation procedures are illustrative only, using them or similar procedures ordinarily results in a reasonable allocation of an organization's multiple function expenses:

- A study of the organization's activities may be made at the start of each fiscal year to determine the best practicable allocation methods. The study should include an evaluation of the preceding year's time records or activity reports of key personnel, the use of space, the consumption of supplies and postage, and so forth. The results of the study should be reviewed periodically, and the allocation methods should be revised, if necessary, to reflect significant changes in the nature or level of the organization's current activities.
- Periodic time and expense records may be kept by employees who spend time on more than one function as a basis for allocating salaries and related costs. The records should indicate the nature of the activities in which the employee is involved. If the functions do not vary significantly from period to pe-

riod, the preparation of time reports for selected test periods during the year might be sufficient.

- Automobile and travel costs may be allocated on the basis of the expense or time reports of the employees involved.
- Telephone expense may be allocated on the basis of use by extensions, generally following the charge assigned to the salary of the employee using the telephone, after making direct charges for the toll calls or other service attributable to specific functions.
- Stationery, supplies, and postage costs may be allocated based on a study of their use.
- Occupancy costs may be allocated on the basis of a factor determined from a study of the function of the personnel using the space involved.
- Depreciation and rental of equipment may be allocated based on asset usage.

APPENDIX C

.128 Illustrative Financial Statements

The following illustrative financial statements (exhibits 1 through 13) demonstrate the practical applications of the reporting practices discussed in this statement of position. Specific types of nonprofit organizations have been selected to illustrate a wide diversity of reporting practices; it is not intended that these illustrations represent either the only types of disclosure or the only statement formats that would be appropriate. Nonprofit organizations are urged to develop financial statement formats that are appropriate for their individual circumstances while being consistent with the accounting and reporting practices discussed in this document.

The notes to the financial statements in exhibit 1 are representative of the basic types of disclosure a typical nonprofit organization would include in its financial report. To avoid unnecessary repetition, the notes to the financial statements of exhibits 2 through 13 have been condensed to indicate only major topics of disclosure, except in those instances in which it is appropriate to include additional items that are unique to a particular type of nonprofit organization.

For conciseness, only some of the sample financial statements have been presented in comparative format. As noted in the text of the statement, the division encourages the presentation of comparative statements.

Index to Illustrative Financial Statements

<i>Exhibit No.</i>		<i>Paragraph No.</i>
1	Independent School .....	.129
2	Cemetery Organization .....	.130
3	Country Club .....	.131
4	Library .....	.132
5	Museum .....	.133
6	Performing Arts Organization.....	.134
7	Private Foundation .....	.135
8	Public Broadcasting Station.....	.136
9	Religious Organization .....	.137
10	Research and Scientific Organization.....	.138
11	Trade Association139
12	Union140
13	Zoological and Botanical Society.....	.141

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.129

EXHIBIT 1—INDEPENDENT SCHOOL**EXHIBIT 1A****Sample Independent School****Balance Sheet****June 30, 19X1**

	<u>Operating Funds</u>	<u>Plant Funds</u>	<u>Endowment Funds</u>	<u>Total All Funds</u>
Assets				
Cash	\$ 87,000	\$ 15,000	\$ 19,000	\$ 121,000
Accounts receivable, less allowance for doubtful receivables of \$3,000	34,000	—	—	34,000
Pledges receivable, less allowance for doubtful pledges of \$10,000	—	75,000	—	75,000
Inventories, at lower of cost (FIFO) or market	7,000	—	—	7,000
Investments (Note 2)	355,000	10,000	100,000	465,000
Land, buildings, equipment, and library books, at cost less accumulated depreciation of \$980,000 (Note 3)	—	2,282,000	—	2,282,000
Other assets	17,000	—	—	17,000
Total assets	<u>\$500,000</u>	<u>\$2,382,000</u>	<u>\$119,000</u>	<u>\$3,001,000</u>
Liabilities and Fund Balances				
Accounts payable and accrued expenses	\$ 13,000	—	—	\$ 13,000
Deferred amounts (Note 6)				
Unrestricted	86,000	—	—	86,000
Restricted	27,000	\$ 100,000	—	127,000
Long-term debt (Note 4)	—	131,000	—	131,000
Total liabilities	<u>126,000</u>	<u>231,000</u>	<u>—</u>	<u>357,000</u>
Fund balances				
Unrestricted				
Designated by the governing board for long-term investment	355,000	—	—	355,000
Undesignated	19,000	—	—	19,000
	<u>374,000</u>	<u>—</u>	<u>—</u>	<u>374,000</u>
Restricted—nonexpendable	—	—	\$119,000	119,000
Net investment in plant	—	2,151,000	—	2,151,000
Total fund balances	<u>374,000</u>	<u>2,151,000</u>	<u>119,000</u>	<u>2,644,000</u>
Total liabilities and fund balances	<u>\$500,000</u>	<u>\$2,382,000</u>	<u>\$119,000</u>	<u>\$3,001,000</u>

Statements of Position

EXHIBIT 1B
Sample Independent School
Statement of Support and Revenue, Expenses,
Capital Additions, and Changes in Fund Balances
Year Ended June 30, 19X1

	Operating Funds		Total	Plant Funds	Endowment Funds	Total All Funds
	Unrestricted	Restricted				
Support and revenue						
Tuition and fees	\$ 910,000	—	\$ 910,000	—	—	\$ 910,000
Contributions	104,000	\$80,500	184,500	—	—	184,500
Endowment and other investment income	23,000	1,500	24,500	—	—	24,500
Net loss on investment transactions	(8,000)	—	(8,000)	—	—	(8,000)
Auxiliary activities	25,000	—	25,000	—	—	25,000
Summer school and other programs	86,000	—	86,000	—	—	86,000
Other sources	26,000	—	26,000	—	—	26,000
Total support and revenue	1,166,000	82,000	1,248,000	—	—	1,248,000
Expenses						
Program services						
Instruction and student activities	798,000	43,000	841,000	\$ 69,000	—	910,000
Auxiliary activities	24,000	—	24,000	—	—	24,000
Summer school and other programs	91,000	—	91,000	7,000	—	98,000
Financial aid	—	37,000	37,000	3,000	—	40,000
Total program services	913,000	80,000	993,000	79,000	—	1,072,000

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EXHIBIT 1C

Sample Independent School
Statement of Changes in Financial Position
Year Ended June 30, 19X1

	<u>Operating Funds</u>	<u>Plant Funds</u>	<u>Endowment Funds</u>	<u>Total All Funds</u>
Resources provided				
Excess (deficiency) of support and revenue over expenses before capital additions	\$ 94,000	\$ (93,000)	—	\$ 1,000
Capital additions				
Contributions and bequests	—	80,000	\$ 30,000	110,000
Investment income	—	5,000	—	5,000
Net gain on investments	<u>—</u>	<u>1,000</u>	<u>2,000</u>	<u>3,000</u>
Excess (deficiency) of support and revenue over expenses after capital additions	94,000	(7,000)	32,000	119,000
Items not using (providing) resources				
Provision for depreciation	—	93,000	—	93,000
Net (gain) loss on investment transactions	8,000	(1,000)	(2,000)	5,000
Decrease in inventories	2,000	—	—	2,000
Increase in deferred amounts	3,000	75,000	—	78,000
Proceeds from sale of investments	<u>160,000</u>	<u>2,000</u>	<u>47,000</u>	<u>209,000</u>
Total resources provided	<u>267,000</u>	<u>162,000</u>	<u>77,000</u>	<u>506,000</u>
Resources used				
Purchases of equipment	—	145,000	—	145,000
Reduction of long-term debt	—	52,000	—	52,000
Purchases of investments	210,000	6,000	136,000	352,000
Increase in other assets	1,000	—	—	1,000
Increase in accounts and pledges receivable	3,000	60,000	—	63,000
Decrease in accounts payable and accrued expenses	<u>3,000</u>	<u>—</u>	<u>—</u>	<u>3,000</u>
Total resources used	<u>217,000</u>	<u>263,000</u>	<u>136,000</u>	<u>616,000</u>
Transfers				
Equipment acquisitions and principal debt service payments	(111,000)	111,000	—	—
Realized gains on endowment funds utilized	<u>4,000</u>	<u>—</u>	<u>(4,000)</u>	<u>—</u>
Total transfers	<u>(107,000)</u>	<u>111,000</u>	<u>(4,000)</u>	<u>—</u>
Increase (decrease) in cash	<u>\$ (57,000)</u>	<u>\$ 10,000</u>	<u>\$ (63,000)</u>	<u>\$(110,000)</u>

EXHIBIT 1D

Sample Independent School

Notes to Financial Statements

Year Ended June 30, 19X1

Note 1—Summary of Significant Accounting Policies

The financial statements of Sample Independent School have been prepared on the accrual basis. The significant accounting policies followed are described below to enhance the usefulness of the financial statements to the reader.

Fund Accounting

To ensure observance of limitations and restrictions placed on the use of resources available to the school, the accounts of the school are maintained in accordance with the principles of fund accounting. This is the procedure by which resources for various purposes are classified for accounting and reporting purposes into funds established according to their nature and purposes. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds that have similar characteristics have been combined into fund groups. Accordingly, all financial transactions have been recorded and reported by fund group.

The assets, liabilities, and fund balances of the school are reported in three self-balancing fund groups as follows:

- Operating funds, which include unrestricted and restricted resources, represent the portion of expendable funds that is available for support of school operations.
- Plant funds represent resources restricted for plant acquisitions and funds expended for plant.
- Endowment funds represent funds that are subject to restrictions of gift instruments requiring in perpetuity that the principal be invested and the income only be used.

Expendable Restricted Resources

Operating and plant funds restricted by the donor, grantor, or other outside party for particular operating purposes or for plant acquisitions are deemed to be earned and reported as revenues of operating funds or as additions to plant funds, respectively, when the school has incurred expenditures in compliance with the specific restrictions. Such amounts received but not yet earned are reported as restricted deferred amounts.

Plant Assets and Depreciation

Uses of operating funds for plant acquisitions and principal debt service payments are accounted for as transfers to plant funds. Proceeds from the sale of plant assets, if unrestricted, are transferred to operating fund balances, or, if restricted, to deferred amounts restricted for plant acquisitions. Depreciation of buildings and equipment is provided over the estimated useful lives of the respective assets on a straight-line basis.

Other Matters

All gains and losses arising from the sale, collection, or other disposition of investments and other noncash assets are accounted for in the fund that owned the assets. Ordinary income from investments, receivables, and the like is accounted for in the fund owning the assets, except for income derived from investments of endowment funds, which is accounted for, if unrestricted, as revenue of the expendable operating fund or, if restricted, as deferred amounts until the terms of the restriction have been met.

Legally enforceable pledges less an allowance for uncollectible amounts are recorded as receivables in the year made. Pledges for support of current operations are recorded as operating fund support. Pledges for support of future operations and plant acquisitions are recorded as deferred amounts in the respective funds to which they apply.

Note 2—Investments

Investments are presented in the financial statements in the aggregate at the lower of cost (amortized, in the case of bonds) or fair market value.

	<u>Cost</u>	<u>Market</u>
Operating funds	\$355,000	\$365,000
Plant funds	10,000	11,000
Endowment funds	<u>100,000</u>	<u>109,000</u>
	<u>\$465,000</u>	<u>\$485,000</u>

Investments are composed of the following:

	<u>Cost</u>	<u>Market</u>
Corporate stocks and bonds	\$318,000	\$320,000
U.S. government obligations	141,000	159,000
Municipal bonds	<u>6,000</u>	<u>6,000</u>
	<u>\$465,000</u>	<u>\$485,000</u>

The following tabulation summarizes the relationship between carrying values and market values of investment assets.

	<u>Carrying Value</u>	<u>Market Value</u>	<u>Excess of Market Over Cost</u>
Balance at end of year	<u>\$465,000</u>	<u>\$485,000</u>	\$ 20,000
Balance at beginning of year	<u>\$327,000</u>	<u>\$335,000</u>	<u>8,000</u>
Increase in unrealized appreciation			12,000
Realized net loss for year			<u>(5,000)</u>
Total net gain for year			<u>\$ 7,000</u>

The average annual yield exclusive of net gains (losses) was 7% and the annual total return based on market value was 9% for the year ended June 30, 19X1.

Note 3—Plant Assets and Depreciation

A summary of plant assets follows.

Land	\$ 255,000
Buildings	2,552,000
Equipment	340,000
Library books	<u>115,000</u>
	3,262,000
Less accumulated depreciation	<u>980,000</u>
	<u><u>\$2,282,000</u></u>

Note 4—Long-Term Debt

A summary of long-term debt follows.

7½% unsecured notes payable to bank due in quarterly installments of \$2,500	\$ 29,000
8½% mortgage payable in semiannual installments of \$3,500 through 19X7	<u>102,000</u>
	<u><u>\$131,000</u></u>

Note 5—Pension Plans

The school has noncontributory pension plans covering all personnel. Total pension expense for the year ended June 30, 19X1, was \$60,000, which includes amortization of prior service costs over a period of twenty years. The school's policy is to fund pension costs accrued. The actuarially computed value of vested benefits as of June 30, 19X1, exceeds net assets of the pension fund by approximately \$100,000.

Note 6—Changes in Deferred Restricted Amounts

	<i>Operating Funds</i>	<i>Plant Fund</i>
Balances at beginning of year	\$ 24,000	\$ 25,000
Additions		
Contributions and bequests	79,000	158,000
Investment income	6,000	1,000
Net gain on investment transactions	<u>—</u>	<u>2,000</u>
	109,000	186,000
Deductions—funds expended during the year	<u>82,000</u>	<u>86,000</u>
Balances at end of year	<u><u>\$ 27,000</u></u>	<u><u>\$100,000</u></u>

Note 7—Functional Allocation of Expenses

The costs of providing the various programs and other activities have been summarized on a functional basis in the statement of support and rev-

enue, expenses, capital additions, and changes in fund balances. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Note 8—Commitments

The school has entered into various agreements aggregating approximately \$80,000 for the purchase of equipment to be received subsequent to June 30, 19X1.

EXHIBIT 2—CEMETERY ORGANIZATION**EXHIBIT 2A**

Sample Cemetery Organization
Balance Sheet
June 30, 19X1, and 19X0

Assets	19X1	19X0	Liabilities and Fund Balance	19X1	19X0
Current			Current		
Cash	\$ 47,000	\$ 27,000	Accounts payable	\$ 90,000	\$ 41,000
Receivables, net	15,000	15,000	Accrued expenses	12,000	8,000
Inventory of supplies	55,000	46,000	Portion of long-term debt currently due	30,000	30,000
Prepaid expenses	4,000	3,000	Total current liabilities	132,000	79,000
Total current assets	121,000	91,000	Long-term debt (Note 4)	240,000	270,000
Inventory					
Investment in real estate	370,000	370,000			
Space development	197,000	110,000			
Total inventory	567,000	480,000			
Property, plant, and equipment, at cost (Note 2)			Fund balance		
Land, other than burial spaces	125,000	125,000		404,000	397,000
Buildings	105,000	105,000			
Equipment	75,000	70,000			
	305,000	300,000			
Less accumulated depreciation	217,000	125,000			
Fixed assets, net	88,000	175,000			
Total	\$776,000	\$746,000	Total	\$776,000	\$746,000

EXHIBIT 2B

Sample Cemetery Organization
Statement of Revenue and Expenses
Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Revenue		
Net sales		
Spaces	\$210,000	\$201,000
Memorials and inscriptions	36,000	30,000
Interment fees	20,000	14,000
Other fees	<u>6,000</u>	<u>2,000</u>
Total	<u>272,000</u>	<u>247,000</u>
Cost of sales		
Spaces	150,000	151,000
Memorials	19,000	14,000
Burial services	<u>16,000</u>	<u>13,000</u>
Total	<u>185,000</u>	<u>178,000</u>
Gross margin	<u>87,000</u>	<u>69,000</u>
Expenses		
Maintenance	60,000	50,000
General administration	30,000	18,000
Commissions	<u>10,000</u>	<u>9,000</u>
Total	<u>100,000</u>	<u>77,000</u>
Operating margin	(13,000)	(8,000)
Other revenue		
Income from care and maintenance funds (Note 3)	<u>20,000</u>	<u>13,000</u>
Excess of revenue over expenses	7,000	5,000
Fund balance—beginning	<u>397,000</u>	<u>392,000</u>
Fund balance—ending	<u>\$404,000</u>	<u>\$397,000</u>

EXHIBIT 2C

Sample Cemetery Organization
Statement of Changes in Financial Position
Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Source of cash		
Excess of revenue over expenses	\$ 7,000	\$ 5,000
Charges not requiring (providing) cash in the current period—depreciation and amortization	<u>92,000</u>	<u>74,000</u>
Cash provided from operations	99,000	79,000
Increases in accounts payable and accrued expenses	<u>53,000</u>	<u>14,000</u>
Total sources of cash	<u>152,000</u>	<u>93,000</u>
Uses of cash		
Space development and equipment	92,000	40,000
Increase in accounts receivable	—	15,000
Reduction of long-term debt	30,000	30,000
Increase in supplies and prepaid expenses	<u>10,000</u>	<u>2,000</u>
Total uses of cash	<u>132,000</u>	<u>87,000</u>
Increases in cash	20,000	6,000
Cash, beginning of year	<u>27,000</u>	<u>21,000</u>
Cash, end of year	<u>\$ 47,000</u>	<u>\$ 27,000</u>

EXHIBIT 2D

Sample Cemetery Organization**Notes to Financial Statements*****June 30, 19X1, and 19X0****Note 1—Summary of Significant Accounting Policies**

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Revenue Recognition

Sales of spaces are recorded when contracts of sales are signed.

Cost of Spaces Sold

The cost of each space sold is computed based on allocation of total expenses incurred in developing the cemetery.

Note 2—Property, Plant, and Equipment**Note 3—Maintenance Funds***General Maintenance*

Under the State Cemetery Act, Sample Cemetery is required, among other things, to collect and pay into a general maintenance fund the following fees and charges:

Fifteen percent (15%) of the gross sales price of each plot sold.

Ten dollars (\$10) for each interment.

Five cents (\$.05) per square unit of surface area of the base of a memorial.

The general maintenance fund principal is restricted by the State Cemetery Act for major improvements and repairs and, accordingly, is not included in the financial statements. At June 30, 19X1, and 19X0 this fund amounted to \$383,000 and \$338,000, respectively. Investment income is unrestricted and is included in other income.

Specific Trusts

Specific trust funds are restricted for flowers, seeding, sodding, and other maintenance of the specific plots as prescribed by the external source and are not available for general use by the cemetery. During the years ended

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

June 30, 19X1, and June 30, 19X0, \$11,000 and \$2,000, respectively, were expended for specific trust maintenance and have been reflected in the statement of revenue and expense.

Note 4—Long-Term Debt

Note 5—Functional Allocation of Expenses

Note 6—Commitments

EXHIBIT 3—COUNTRY CLUB

EXHIBIT 3A
Sample Country Club
Balance Sheet
March 31, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Assets		
Current assets		
Cash	\$ 44,413	\$ 37,812
Investments (Note 2)	289,554	388,007
Accounts receivable, less allowances of \$5,000 in 19X1, and \$6,000 in 19X0	71,831	45,898
Inventories, at lower of cost (FIFO) or market	27,930	28,137
Prepaid expenses	<u>19,154</u>	<u>13,948</u>
Total current assets	<u>452,882</u>	<u>513,802</u>
Property and equipment, at cost (Note 3)		
Land and land improvements	1,085,319	1,098,828
Buildings	1,331,590	1,200,585
Furniture, fixtures, and equipment	<u>274,761</u>	<u>254,540</u>
	2,691,670	2,553,953
Less accumulated depreciation	<u>864,564</u>	<u>824,088</u>
	<u>1,827,106</u>	<u>1,729,865</u>
Other assets		
Deferred charges	15,077	16,524
Beverage license	<u>10,500</u>	<u>10,500</u>
	<u>25,577</u>	<u>27,024</u>
	<u>\$2,305,565</u>	<u>\$2,270,691</u>
Liabilities and Membership Equity		
Current liabilities		
Accounts payable and accrued expenses	\$ 61,426	\$ 63,600
Deferred revenues—initiation fees (Note 1)	15,677	7,755
Due to resigned members	16,400	12,900
Taxes	<u>20,330</u>	<u>23,668</u>
Total current liabilities	<u>113,833</u>	<u>107,923</u>
Membership equity		
Proprietary certificates, 500 at \$1,500 each— no change during the years	750,000	750,000
Cumulative excess of revenue over expenses	<u>1,441,732</u>	<u>1,412,768</u>
	<u>2,191,732</u>	<u>2,162,768</u>
	<u>\$2,305,565</u>	<u>\$2,270,691</u>

EXHIBIT 3B

Sample Country Club

**Statement of Revenue, Expenses, and Changes in
Cumulative Excess of Revenue Over Expenses**

Years Ended March 31, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Revenue		
Dues	\$ 590,000	\$ 600,000
Restaurant and bar charges	270,412	265,042
Greens fees	171,509	163,200
Tennis and swimming fees	83,829	67,675
Initiation fees	61,475	95,220
Locker and room rentals	49,759	49,954
Interest and discounts	28,860	28,831
Golf cart rentals	26,584	24,999
Other—net	4,011	3,893
Total revenue	<u>1,286,439</u>	<u>1,298,814</u>
Expenses		
Greens	241,867	244,823
House	212,880	210,952
Restaurant and bar	153,035	136,707
Tennis and swimming	67,402	48,726
General and administrative	533,838	690,551
Net (gains) losses on investments	98,453	(98,813)
Total expenses	<u>1,307,475</u>	<u>1,232,946</u>
Excess (deficiency) of revenue over expenses before capital additions	(21,036)	65,868
Capital additions		
Assessments for capital improvements	<u>50,000</u>	<u>—</u>
Excess (deficiency) of revenue over expenses after capital additions	28,964	65,868
Cumulative excess of revenue over expenses— beginning of year	<u>1,412,768</u>	<u>1,346,900</u>
Cumulative excess of revenue over expenses—end of year	<u>\$1,441,732</u>	<u>\$1,412,768</u>

EXHIBIT 3C

Sample Country Club**Statement of Changes in Financial Position**
Years Ended March 31, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Sources of funds		
Excess (deficiency) of revenue over expenses before capital additions	\$ (21,036)	\$ 65,868
Capital additions	<u>50,000</u>	<u>—</u>
Excess (deficiency) of revenue over expenses after capital additions	28,964	65,868
Add-back provision for depreciation, which does not affect working capital	<u>40,476</u>	<u>61,618</u>
Total from operations	69,440	127,486
Decrease in deferred charges—net	<u>1,447</u>	<u>—</u>
Total sources	<u>70,887</u>	<u>127,486</u>
Applications of funds		
Purchases of property and equipment	137,717	84,377
Increase in deferred charges—net	<u>—</u>	<u>8,909</u>
Total applications	<u>137,717</u>	<u>93,286</u>
Increase (decrease) in working capital	<u>\$ (66,830)</u>	<u>\$ 34,200</u>
Changes in the components of working capital are summarized as follows:		
Increase (decrease) in current assets		
Cash	\$ 6,601	\$ (70,928)
Investments	(98,453)	98,813
Accounts receivable	25,933	5,000
Inventories	(207)	8,112
Prepaid expenses	<u>5,206</u>	<u>2,056</u>
	<u>(60,920)</u>	<u>43,053</u>
(Increase) decrease in current liabilities		
Accounts payable and accrued expenses	2,174	(5,597)
Deferred revenues—initiation fees	(7,922)	(3,517)
Due to resigned members	(3,500)	(2,700)
Taxes	<u>3,338</u>	<u>2,961</u>
	<u>(5,910)</u>	<u>(8,853)</u>
Increase (decrease) in working capital	<u>\$ (66,830)</u>	<u>\$ 34,200</u>

EXHIBIT 3D

Sample Country Club
Notes to Financial Statements*
March 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Principles

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Membership Dues and Initiation Fees

Membership dues are recognized as revenue in the applicable membership period. Initiation fees are recorded as revenue in the period when the fees are due.

Note 2—Investments

Note 3—Property and Equipment and Depreciation

Note 4—Pension Plans

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

Statements of Position

EXHIBIT 4—LIBRARY

EXHIBIT 4A
Sample Library
Balance Sheet
December 31, 19X1
(With Comparative Totals for 19X0)

	December 31, 19X1				December 31, 19X0			
	Unrestricted		Current		Unrestricted		Current	
	Operating	Investment	Total	Restricted	Plant	Endowment	Total	Total
\$ 690,000	—	\$ 690,000	\$ 3,000	\$ 7,000	—	—	\$ 700,000	\$ 411,000
375,000	—	375,000	75,000	—	—	—	450,000	525,000
120,000	—	120,000	—	—	—	—	120,000	161,000
30,000	—	30,000	27,000	8,000	—	—	65,000	35,000
15,000	—	15,000	—	—	—	—	15,000	15,000
70,000	—	70,000	—	—	—	—	70,000	85,000
1,300,000	—	1,300,000	105,000	15,000	—	—	1,420,000	1,232,000
—	\$920,000	920,000	—	165,000	\$985,000	2,070,000	2,172,000	—
—	—	—	—	1,525,000	—	—	1,525,000	1,491,000
—	—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—	—
\$1,300,000	\$920,000	\$2,220,000	\$105,000	\$1,705,000	\$985,000	\$5,015,000	\$4,895,000	—

Assets

Current assets
Cash, including interest-bearing accounts of \$600,000 in 19X1, and \$400,000 in 19X0
Certificates of deposit
Grants receivable (Note 1)
Governments
Other
Pledges receivable, at estimated net realizable value (Note 1)
Prepaid expenses and other current assets
Total current assets
Investments—at market (Note 2)
Land, buildings, and equipment—at cost, less accumulated depreciation of \$90,000 and \$79,000, respectively (Note 3)
Inexhaustible collections and books (Note 1)
Total assets

EXHIBIT 4B
Sample Library
Statement of Support, Revenue, and Expenses and Changes in Fund Balances
Year Ended December 31, 19X1
(With Comparative Totals for 19X0)

	Year Ended December 31, 19X1					Year Ended December 31, 19X0				
	Unrestricted		Current		Endowment	Unrestricted		Current		Endowment
	Operating	Investment	Total	Restricted		Operating	Investment	Total	Restricted	
Support and revenue										
Support										
Grants (Note 1)										
Governments	\$ 150,000	—	\$ 150,000	—	—			\$ 150,000	—	\$ 150,000
Other	25,000	—	25,000	—	—			25,000	—	—
Contributions, legacies, and bequests (Note 1)	350,000	\$ 90,000	440,000	\$75,000	—			515,000	—	490,000
Contributed services of volunteers (Note 1)	75,000	—	75,000	—	—			75,000	—	50,000
Use of contributed facilities (Note 1)	47,000	—	47,000	—	—			47,000	—	50,000
Total support	647,000	90,000	737,000	75,000	—			812,000	—	740,000
Revenue										
Fees for services	50,000	—	50,000	—	—			50,000	—	45,000
Book rentals and fines	320,000	—	320,000	—	—			320,000	—	250,000
Investment income including net gains	25,000	93,000	118,000	10,000	—			128,000	—	103,000
Total revenue	395,000	93,000	488,000	10,000	—			498,000	—	398,000
Total support and revenue	1,042,000	183,000	1,225,000	85,000	—			1,310,000	—	1,138,000

Expenses (Note 7)									
Program services									
Circulating library	390,000	—	390,000	75,000	\$	5,000	—	470,000	430,000
Research library	169,000	—	169,000	—		1,000	—	170,000	155,000
Collections and exhibits	49,000	—	49,000	10,000		1,000	—	60,000	50,000
Educational services	49,000	—	49,000	—		1,000	—	50,000	55,000
Community services	29,500	—	29,500	—		500	—	30,000	20,000
Total program services	686,500	—	686,500	85,000		8,500	—	780,000	710,000
Supporting services									
General administration	315,500	3,000	318,500	—		21,500	—	340,000	290,000
Fund raising	200,000	—	200,000	—		5,000	—	205,000	200,000
Total supporting services	515,500	3,000	518,500	—		26,500	—	545,000	490,000
Total expenses	1,202,000	3,000	1,205,000	85,000		35,000	—	1,325,000	1,200,000
Excess (deficiency) of support and revenue over expenses before capital additions	(160,000)	180,000	20,000	—		(35,000)	—	(15,000)	(62,000)
Capital additions									
Contributions	—	—	—	—		40,000	—	40,000	95,000
Investment income including net gains	—	—	—	—		5,000	—	5,000	17,000
Contributed materials, equipment, etc (Note 1)	—	—	—	—		10,000	—	10,000	—
Excess (deficiency) of support and revenue over expenses after capital additions	—	—	—	—		55,000	—	55,000	112,000
Fund balances at beginning of year	(160,000)	180,000	20,000	—		20,000	—	40,000	50,000
Mandatory transfers—principal of indebtedness	1,270,000	740,000	2,010,000	—		1,480,000	\$985,000	4,475,000	4,425,000
Fund balances at end of year	(10,000)	—	(10,000)	—		10,000	—	—	—
	\$1,100,000	\$920,000	\$2,020,000	—		\$1,510,000	\$985,000	\$4,515,000	\$4,475,000

EXHIBIT 4C
Sample Library
Statement of Changes in Financial Position
Year Ended December 31, 19X1 (With Comparative Totals for 19X0)

	Year Ended December 31, 19X1				Year Ended December 31, 19X0	
	Unrestricted		Current		Total	
	Operating	Investment	Total •	Restricted	Plant	Total
Sources of working capital						
Excess (deficiency) of support and revenue over expenses before capital additions	\$ (160,000)	\$ 180,000	\$ 20,000	—	\$ (35,000)	\$ (62,000)
Capital additions	—	—	—	—	55,000	112,000
Excess (deficiency) of support and revenue over expenses after capital additions	(160,000)	180,000	20,000	—	20,000	50,000
Add (deduct) items not using (providing) working capital	—	—	—	—	—	—
Depreciation	—	—	—	—	11,000	11,000
Contributed equipment	—	—	—	—	(10,000)	—
Working capital provided by operations	(160,000)	180,000	20,000	—	21,000	61,000
Deferred restricted contributions and investment income received	—	—	—	\$ 85,000	—	100,000
Sale of investments	22,000	245,000	267,000	—	—	110,000
	(138,000)	425,000	287,000	85,000	21,000	271,000

§ 10,250.132

EXHIBIT 4D

Sample Library
Notes to Financial Statements*
December 31, 19X1

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Contributed Facilities

The library occupies without charge certain premises located in government-owned buildings. The estimated fair rental value of the premises is reported as support and expense in the period in which the premises are used.

Grants

The library records income from unrestricted grants in the period designated by the grantor.

Inexhaustible Collections and Books

Because the values of the existing inexhaustible collections, including research books, are not readily determinable, the library has not capitalized them. Collections that are exhaustible are capitalized and included with equipment in the financial statements and are amortized over their estimated useful lives. Accessions and deaccessions during 19X0 and 19X1 were not significant. Books used in the circulating library have not been capitalized because their estimated useful lives are less than one year.

Summarized Financial Information for 19X0

The financial information for the year ended December 31, 19X0, presented for comparative purposes, is not intended to be complete financial statement presentation.

Note 2—Investments**Note 3—Plant Assets and Depreciation****Note 4—Long-Term Debt****Note 5—Pension Plans****Note 6—Changes in Deferred Restricted Amounts****Note 7—Functional Allocation of Expenses**

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

Note 8—Commitments and Contingencies

The library receives a substantial amount of its support from federal, state, and local governments. A significant reduction in the level of this support, if this were to occur, may have an effect on the library's programs and activities.

EXHIBIT 5—MUSEUM

EXHIBIT 5A
Sample Museum
Balance Sheet
June 30, 19X1
(With Comparative Totals for 19X0)

	Operating Fund	Plant Fund	Endowment Fund	Total	June 30, 19X0 Total
Assets					
Current assets					
Cash	\$ 19,800	—	—	\$ 19,800	\$ 23,700
Receivables, less reserve of \$7,700	145,500	—	—	145,500	125,800
Investments (Note 2)	210,000	—	—	210,000	—
Inventories, at lower of cost (FIFO) or market	121,100	—	—	121,100	120,600
Prepayments	26,600	—	—	26,600	12,700
Total current assets	523,000	—	—	523,000	282,800
Fixed assets, net of depreciation (Note 3)	—	\$1,964,000	—	1,964,000	1,866,800
Art collection (Note 11)	—	—	\$ 6,000	6,000	3,800
Cash held for investment	4,044,500	—	7,688,400	11,732,900	11,709,300
Investments (Note 2)	\$4,567,500	\$1,964,000	\$7,694,400	\$14,225,900	\$13,862,700
Total					

Liabilities and Fund Balances

Current liabilities					
Accounts payable and accrued expenses					
Deferred revenue and restricted gifts, current portion (Note 5)					
Total current liabilities					
Deferred revenue and restricted gifts, noncurrent portion (Note 5)					
Fund balances					
Endowment					
Land, buildings, and equipment					
Unrestricted					
Designated for investment					
Designated for plant expansion					
Unappropriated					
Total fund balances					
Total					

Statements of Position

EXHIBIT 5B
Sample Museum
Statement of Activity
Year Ended June 30, 19X1
(With Comparative Totals for 19X0)

	Operating Fund	Plant Fund	Endowment Fund	Total	Year Ended June 30, 19X0 Total
Support and revenue					
Admissions	\$ 131,100	—	—	\$ 131,100	\$ 123,400
Government appropriations	110,700	—	—	110,700	104,000
Gifts and grants (Notes 5 and 8)	130,000	—	—	130,000	124,700
Memberships	48,400	—	—	48,400	39,900
Investment income	828,800	—	—	828,800	841,700
Net realized investment gains (losses)	6,300	—	—	6,300	(2,600)
Revenue, auxiliary activities	483,100	—	—	483,100	417,200
Total	1,738,400	—	—	1,738,400	1,648,300

18,647

§ 10,250.133

Statements of Position

EXHIBIT 5C

Sample Museum**Statement of Changes in Financial Position****Year Ended June 30, 19X1**

Sources of working capital

Excess of support and revenue before capital additions	\$ 10,000
Capital additions	<u>72,600</u>
Excess of support and revenue after capital additions	82,600
Depreciation	54,400
Deferred revenue and restricted gifts	
received in excess of expenses incurred	242,600
Investments sold	<u>952,200</u>
	<u>1,331,800</u>

Uses of working capital

Fixed assets purchased	151,600
Investments purchased	<u>978,000</u>
	<u>1,129,600</u>

Increase in working capital

\$ 202,200

Changes in working capital, increase (decrease)

Cash	\$ (3,900)
Receivables	19,700
Investments	210,000
Inventories	500
Prepayments	13,900
Accounts payable and accrued expenses	(4,000)
Deferred revenue and restricted gifts, current portion	<u>(34,000)</u>
	<u>\$ 202,200</u>

EXHIBIT 5D

Sample Museum

Notes to Financial Statements*

June 30, 19X1

Note 1—Summary of Significant Accounting Policies

Note 2—Investments

Note 3—Fixed Assets and Depreciation

Note 4—Pension Plans

Note 5—Deferred Revenue and Restricted Gifts

Note 6—Functional Allocation of Expenses

Note 7—Commitments

Note 8—Gifts Received

Note 9—Interfund Transfers

During the year ended June 30, 19X1, the trustees authorized a transfer from the Operating Fund to the Plant Fund in the amount of \$151,600 representing fixed assets purchased with resources of the Operating Fund.

Note 10—Contributed Services

A substantial number of unpaid volunteers have made significant contributions of their time to develop the Museum's programs, principally in membership development and educational programs. The value of this contributed time is not reflected in these statements since it is not susceptible to objective measurement or valuation.

Note 11—Art Collection

In conformity with the practice followed by many museums, art objects purchased and donated are not included in the balance sheet.

The value of the objects acquired by gift for which the Museum can make a reasonable estimate is reported as gifts in the Statement of Activity (\$28,000 in the year ended June 30, 19X1).

The cost of all objects purchased together with the value of objects acquired by gift as indicated in the preceding paragraph, less the proceeds from deaccessions of objects, is reported as a separate program expense. During the year ended June 30, 19X1, purchase of art objects amounted to \$185,000 and the proceeds from deaccessions was \$13,000.

Gifts of cash or other property restricted by donors for the purchase of items for the collection are classified as deferred revenue until acquisitions are made in accordance with the terms of the gifts.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.134 EXHIBIT 6—PERFORMING ARTS ORGANIZATION

EXHIBIT 6A
Sample Performing Arts Organization
Balance Sheet
June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Assets		
Current assets		
Cash	\$216,074	\$169,466
Marketable securities (Note 2)	266,330	50,967
Accounts receivable, net of allowance for doubtful accounts	70,051	26,685
Grants receivable	—	6,100
Other	<u>39,378</u>	<u>13,441</u>
Total current assets	591,833	266,659
Noncurrent assets		
Investments and endowment funds cash (Note 2)	267,869	256,648
Property and equipment at cost, net of accumulated depreciation (Note 3)	55,061	40,226
Rent and other deposits	<u>3,839</u>	<u>9,130</u>
	<u><u>\$918,602</u></u>	<u><u>\$572,663</u></u>
Liabilities and Entity Capital		
Current liabilities		
Accounts payable and accrued expenses	\$111,150	\$166,351
Deferred revenues—subscriptions (Note 1)	297,430	193,042
Deferred revenues—grants (Note 1)	42,562	—
Current portion of long-term debt	<u>50,000</u>	<u>50,000</u>
Total current liabilities	501,142	409,393
Long-term debt (Note 4)	32,000	69,740
Contingencies (Note 6)		
Entity capital		
Plant fund	33,061	38,594
Endowment funds (Note 5)	267,869	256,648
Unrestricted funds	<u>84,530</u>	<u>(201,712)</u>
	<u><u>\$918,602</u></u>	<u><u>\$572,663</u></u>

EXHIBIT 6B

Sample Performing Arts Organization

Statement of Activity

Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Revenue and support from operations		
Admissions	\$1,557,567	\$1,287,564
Dividends and interest	21,555	2,430
Net realized gains and losses	54,700	18,300
Tuition	242,926	130,723
Concessions and other support	103,582	68,754
	<u>1,980,330</u>	<u>1,507,771</u>
Production costs	476,982	427,754
Operating expenses	797,044	685,522
Ballet school	473,658	301,722
Neighborhood productions	378,454	81,326
General and administrative expense	390,487	469,891
	<u>2,516,625</u>	<u>1,966,215</u>
Deficiency from operations	<u>(536,295)</u>	<u>(458,444)</u>
Donated services, materials, and facilities	—	8,000
Annual giving	150,379	78,469
Grants	702,368	678,322
Fund-raising costs	<u>(35,743)</u>	<u>(50,454)</u>
	<u>817,004</u>	<u>714,337</u>
Excess from current endeavors	280,709	255,893
Capital additions	11,221	18,250
Total increase in entity capital	<u>\$ 291,930</u>	<u>\$ 274,143</u>

EXHIBIT 6C

Sample Performing Arts Organization**Statement of Changes in Entity Capital****Years Ended June 30, 19X1, and 19X0**

	<i>Endowment Funds</i>	<i>Plant Fund</i>	<i>Unrestricted Funds</i>	<i>Total</i>
Entity capital—June 30, 19X9	\$238,398	\$43,214	\$(462,225)	\$(180,613)
Excess from current endeavors	—	(4,620)	260,513	255,893
Capital additions	<u>18,250</u>	<u>—</u>	<u>—</u>	<u>18,250</u>
Entity capital—June 30, 19X0	256,648	38,594	(201,712)	93,530
Excess from current endeavors	—	(5,533)	286,242	280,709
Capital additions	<u>11,221</u>	<u>—</u>	<u>—</u>	<u>11,221</u>
Entity capital—June 30, 19X1	<u>\$267,869</u>	<u>\$33,061</u>	<u>\$ 84,530</u>	<u>\$ 385,460</u>

EXHIBIT 6D

Sample Performing Arts Organization

Statement of Changes in Financial Position

Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Funds provided by		
Excess from current endeavors	\$280,709	\$255,893
Add expenses not requiring outlay of working capital in current period		
Depreciation	5,533	4,620
Other deferred charges	<u>—</u>	<u>7,500</u>
Funds provided from current endeavors	286,242	268,013
Increase in long-term debt	12,260	—
Other	5,291	—
Capital additions	<u>11,221</u>	<u>18,250</u>
Total funds provided	<u>315,014</u>	<u>286,263</u>
Funds applied		
Increase in noncurrent investments and cash	11,221	—
Acquisition of property, plant, and equipment	20,368	4,362
Reduction of long-term debt	<u>50,000</u>	<u>25,280</u>
Total funds applied	81,589	29,642
Increase in working capital	<u>\$233,425</u>	<u>\$256,621</u>
Changes in the components of working capital		
Increase (decrease) in current assets		
Cash	\$ 46,608	\$220,342
Marketable securities	215,363	42,312
Accounts receivable	43,366	21,269
Grants receivable	(6,100)	—
Other	<u>25,937</u>	<u>15,413</u>
Increase in current assets	<u>325,174</u>	<u>299,336</u>
(Increase) decrease in current liabilities		
Accounts payable and accrued expenses	55,201	36,149
Deferred revenues—subscriptions	(104,388)	(78,864)
Deferred revenues—grants	<u>(42,562)</u>	<u>—</u>
(Increase) in current liabilities	<u>(91,749)</u>	<u>(42,715)</u>
Increase in working capital	<u>\$233,425</u>	<u>\$256,621</u>

EXHIBIT 6E

Sample Performing Arts Organization**Notes to Financial Statements****June 30, 19X1, and 19X0***Note 1—Summary of Significant Accounting Policies****Note 2—Investments****Note 3—Property and Equipment****Note 4—Long-Term Debt****Note 5—Endowments**

An endowment in the amount of \$125,000 required the establishment of a ballet school. The second endowment, in the amount of \$100,000, established the organization's neighborhood production program. Income from those endowments, including capital gains, is to be used for those programs.

Note 6—Commitments and Contingencies

The organization leases its theatre and offices under a lease expiring in 19X8 at \$25,000 per year with a renewal option for ten years at the same rent. Heating, ventilating, and air-conditioning are paid separately as common area charges. The lease is not considered a capital lease under FASB Statement 13.

Grants, bequests, and endowments require the fulfillment of certain conditions as set forth in the instrument of grant. Failure to fulfill the conditions, or in the case of endowments, failure to continue to fulfill them, could result in the return of the funds to grantors. Although that is a possibility, the Board deems the contingency remote, since by accepting the gifts and their terms, it has accommodated the objectives of the organization to the provisions of the gift.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 6F

Sample Performing Arts Organization
Schedule of Functional Expenses—Supplementary Schedule
Year Ended June 30, 19X1
(With Comparative Totals for 19X0)

Item of Expense	Program Services				Support Services		
	Production Costs	Operating Expenses	Ballet School	Neighborhood Productions	Total Program Services	General and Administrative	Fund Raising
Salaries, payroll taxes, and employee benefits	\$219,370	\$464,570	\$388,113	\$306,026	\$1,378,079	\$260,755	\$15,782
Professional fees	7,864	—	2,785	—	10,649	15,624	—
Supplies	15,628	17,128	—	3,728	36,484	25,823	—
Telephone	—	—	—	—	—	10,725	1,211
Postage and shipping	—	—	—	—	—	3,816	14,439
Occupancy	—	258,622	82,760	5,478	346,860	41,540	1,527
Rental and maintenance of equipment	—	56,724	—	—	56,724	6,927	2,784
Printing and publications	—	—	—	—	—	10,381	—
Travel	—	—	—	—	—	5,824	—
Conferences, conventions, and meetings	—	—	—	—	—	2,783	—
Membership dues	—	—	—	—	—	756	—
Scenery	154,682	—	—	35,540	190,222	—	—
Costumes	79,438	—	—	27,682	107,120	—	—
Depreciation and amortization	—	—	—	—	—	5,533	—
Total, year ended June 30, 19X1	\$476,982	\$797,044	\$473,658	\$378,454	\$2,126,138	\$390,487	\$35,743
Total, year ended June 30, 19X0	\$427,754	\$685,522	\$301,722	\$ 81,326	\$1,496,324	\$469,891	\$50,454
							\$2,016,669

EXHIBIT 7—PRIVATE FOUNDATION**EXHIBIT 7A****Sample Private Foundation****Balance Sheet****December 31, 19X1, and 19X0**

	<u>19X1</u>	<u>19X0</u>
Assets		
Cash	\$ 75,000	\$ 50,000
Accrued interest and dividends receivable	<u>175,000</u>	<u>225,000</u>
Securities, at market (cost, 19X1—\$17,800,000; 19X0—\$17,400,000) (Note 2)		
U.S. government obligations	2,000,000	1,750,000
Corporate and other obligations	5,000,000	7,000,000
Stocks	<u>12,000,000</u>	<u>10,000,000</u>
	<u>19,000,000</u>	<u>18,750,000</u>
Total assets	<u><u>\$19,250,000</u></u>	<u><u>\$19,025,000</u></u>
Liabilities and Fund Balance		
Federal excise taxes payable (Note 3)	\$ 41,000	\$ 39,000
Accrued expenses payable	9,000	11,000
Deferred taxes	10,000	5,000
Unconditional grants payable	<u>40,000</u>	<u>75,000</u>
Total liabilities	<u>100,000</u>	<u>130,000</u>
Commitments (Note 4)		
Fund balance	<u>19,150,000</u>	<u>18,895,000</u>
Total liabilities and fund balance	<u><u>\$19,250,000</u></u>	<u><u>\$19,025,000</u></u>

EXHIBIT 7B

Sample Private Foundation
Statement of Revenue, Expense, and Changes in Fund Balance
Years Ended December 31, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Revenue and support		
Dividends	\$ 525,000	\$ 500,000
Interest	500,000	585,000
Unrestricted donations	<u>100,000</u>	<u>—</u>
Total revenue and support	<u>1,125,000</u>	<u>1,085,000</u>
Expense		
Program services		
Program grants		
Health	530,000	525,000
Education	390,000	375,000
Program management	<u>82,500</u>	<u>80,000</u>
	<u>1,002,500</u>	<u>980,000</u>
Management and general expenses	72,500	70,000
Provision for federal excise taxes	<u>40,000</u>	<u>38,000</u>
	<u>112,500</u>	<u>108,000</u>
Total expense	<u>1,115,000</u>	<u>1,088,000</u>
Excess (deficiency) of revenue and support over expense before gains (losses) on securities	10,000	(3,000)
Net gains (losses) on securities	<u>245,000</u>	<u>(172,000)</u>
Excess (deficiency) for the year	255,000	(175,000)
Fund balance, beginning of year	<u>18,895,000</u>	<u>19,070,000</u>
Fund balance, end of year	<u>\$19,150,000</u>	<u>\$18,895,000</u>

EXHIBIT 7C

Sample Private Foundation**Statement of Changes in Cash****Years Ended December 31, 19X1, and 19X0**

	<u>19X1</u>	<u>19X0</u>
Sources of cash		
Excess (deficiency) for the year	\$ 255,000	\$ (175,000)
Net (gains) losses on securities	(245,000)	172,000
Decrease in accrued interest and dividends receivable	50,000	40,000
Proceeds on disposition of securities	<u>5,105,000</u>	<u>4,000,000</u>
	<u>5,165,000</u>	<u>4,037,000</u>
Uses of cash		
Purchase of securities	5,110,000	4,007,000
Decrease in liabilities	<u>30,000</u>	<u>40,000</u>
	<u>5,140,000</u>	<u>4,047,000</u>
Increase (decrease) in cash for year	25,000	(10,000)
Cash, beginning of year	<u>50,000</u>	<u>60,000</u>
Cash, end of year	<u>\$ 75,000</u>	<u>\$ 50,000</u>

EXHIBIT 7D

Sample Private Foundation

Notes to Financial Statements*

December 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Office Furnishings

Costs of office furnishings and equipment are consistently charged to expense because the foundation does not deem such amounts to be sufficiently material to warrant capitalization and depreciation.

Note 2—Investment in Securities

Note 3—Federal Excise Taxes

In accordance with the applicable provisions of the Tax Reform Act of 1969, the foundation is subject to an excise tax on net investment income, including realized gains, as defined in the act. Accordingly, federal excise taxes have been accrued in amounts of \$41,000 and \$39,000 as of December 31, 19X1, and 19X0, respectively.

In addition, the Tax Reform Act requires that certain minimum distributions be made in accordance with a specified formula. At December 31, 19X1, the foundation had distributed approximately \$200,000 more than the required minimum.

Note 4—Commitments

Trustees of the foundation had approved, as of December 31, 19X1, and 19X0, grants amounting to \$750,000 and \$700,000, respectively. Such grants are subject to the satisfaction by the intended recipients of prior conditions before payment. The commitments outstanding at December 31, 19X1, are scheduled for payment as follows.

<u>Year</u>	<u>Amount</u>
19X2	\$600,000
19X3	100,000
19X4	<u>50,000</u>
	<u>\$750,000</u>

Note 5—Pension Plans

Note 6—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 8—PUBLIC BROADCASTING STATION**EXHIBIT 8A****Sample Public Broadcasting Station****Balance Sheet****December 31, 19X1, and 19X0**

	<u>19X1</u>			<u>19X0</u>
	<u>Unrestricted</u>	<u>Restricted</u>	<u>Total</u>	<u>Total</u>
Assets				
Current assets				
Cash	\$ 78,000	\$ 24,000	\$ 102,000	\$ 71,000
Accounts receivable, principally grants, net of allowance for doubtful accounts of \$4,000 in 19X1, and \$9,000 in 19X0 (Note 2)	192,000	80,000	272,000	245,000
Costs incurred for programs not yet telecast (Note 1)	117,000	74,000	191,000	176,000
Other assets	105,000	—	105,000	89,000
Total current assets	<u>492,000</u>	<u>178,000</u>	<u>670,000</u>	<u>581,000</u>
Property and equipment (Notes 1 and 3)				
Leasehold improvements, net of accumulated amortization of \$154,000 in 19X1, and \$94,000 in 19X0	359,000	—	359,000	374,000
Television and other equipment, net of accumulated depreciation of \$672,000 in 19X1, and \$407,000 in 19X0	1,568,000	—	1,568,000	1,676,000
	<u>1,927,000</u>	<u>—</u>	<u>1,927,000</u>	<u>2,050,000</u>
Total assets	<u>\$2,419,000</u>	<u>\$178,000</u>	<u>\$2,597,000</u>	<u>\$2,631,000</u>
Liabilities and Fund Balance				
Current liabilities				
Accounts payable and accrued expenses	\$ 113,000	—	\$ 113,000	\$ 186,000
Deferred revenue for programs not yet telecast (Notes 1 and 7)	—	\$178,000	178,000	270,000
Current portion of long-term debt (Note 4)	50,000	—	50,000	—
Total current liabilities	163,000	178,000	341,000	456,000
Long-term debt (Note 4)	250,000	—	250,000	300,000
Total liabilities	413,000	178,000	591,000	756,000
Fund balance	2,006,000	—	2,006,000	1,875,000
Total liabilities and fund balance	<u>\$2,419,000</u>	<u>\$178,000</u>	<u>\$2,597,000</u>	<u>\$2,631,000</u>

EXHIBIT 8B

Sample Public Broadcasting Station
Statement of Revenue, Expenses, and
Changes in Fund Balance
Years Ended December 31, 19X1, and 19X0

	19X1			19X0
	<u>Unrestricted</u>	<u>Restricted</u>	<u>Total</u>	<u>Total</u>
Revenue (Note 2)				
Contributions	\$ 946,000	—	\$ 946,000	\$ 790,000
Community service grants	—	\$327,000	327,000	287,000
Other grants	—	189,000	189,000	155,000
Telecasting and production	286,000	—	286,000	302,000
Facilities rental	36,000	—	36,000	31,000
Total revenue	<u>1,268,000</u>	<u>516,000</u>	<u>1,784,000</u>	<u>1,565,000</u>
Expenses				
Program services				
Programming production, including designated projects (Note 1)	274,000	335,000	609,000	563,000
Broadcasting and technical	385,000	—	385,000	279,000
Public information	162,000	—	162,000	134,000
Total program expenses	<u>821,000</u>	<u>335,000</u>	<u>1,156,000</u>	<u>976,000</u>
Supporting services				
General administration	372,000	136,000	508,000	421,000
Fund raising	146,000	45,000	191,000	154,000
Total supporting expenses	<u>518,000</u>	<u>181,000</u>	<u>699,000</u>	<u>575,000</u>
Total expenses	<u>1,339,000</u>	<u>516,000</u>	<u>1,855,000</u>	<u>1,551,000</u>
Excess (deficiency) of revenue over expenses before special grants	(71,000)	<u>—</u>	(71,000)	14,000
Special grants	<u>202,000</u>		<u>202,000</u>	<u>107,000</u>
Excess for the year	131,000		131,000	121,000
Fund balance, beginning of year	<u>1,875,000</u>		<u>1,875,000</u>	<u>1,754,000</u>
Fund balance, end of year	<u>\$2,006,000</u>		<u>\$2,006,000</u>	<u>\$1,875,000</u>

EXHIBIT 8C

Sample Public Broadcasting Station
Statement of Changes in Financial Position
Years Ended December 31, 19X1, and 19X0

	19X1			19X0
	<u>Unrestricted</u>	<u>Restricted</u>	<u>Total</u>	<u>Total</u>
Financial resources were provided by				
Excess (deficiency) of revenue over expenses before special grants	\$ (71,000)	—	\$ (71,000)	\$ 14,000
Special grants	<u>202,000</u>	<u>—</u>	<u>202,000</u>	<u>107,000</u>
Excess for the year	131,000	—	131,000	121,000
Add items not requiring working capital—amortization and depreciation	<u>325,000</u>	<u>—</u>	<u>325,000</u>	<u>281,000</u>
Working capital provided by operations	456,000	—	456,000	402,000
Increase in long-term debt	<u>—</u>	<u>—</u>	<u>—</u>	<u>300,000</u>
Total resources provided	<u>456,000</u>	<u>—</u>	<u>456,000</u>	<u>702,000</u>
Financial resources were used for				
Leasehold improvements	45,000	—	45,000	30,000
Purchases of property and equipment	157,000	—	157,000	457,000
Reduction of long-term debt	<u>50,000</u>	<u>—</u>	<u>50,000</u>	<u>—</u>
Total resources used	<u>252,000</u>	<u>—</u>	<u>252,000</u>	<u>487,000</u>
Increase in working capital	<u>\$204,000</u>	<u>—</u>	<u>\$204,000</u>	<u>\$215,000</u>
Analysis of changes in working capital				
Increase (decrease) in current assets				
Cash	\$ 57,000	\$(26,000)	\$ 31,000	\$ 25,000
Accounts receivable	62,000	(35,000)	27,000	49,000
Costs incurred for programs not yet telecast	46,000	(31,000)	15,000	45,000
Other assets	<u>16,000</u>	<u>—</u>	<u>16,000</u>	<u>21,000</u>
	<u>181,000</u>	<u>(92,000)</u>	<u>89,000</u>	<u>140,000</u>
Decrease (increase) in current liabilities				
Accounts payable and accrued expenses	73,000	—	73,000	32,000
Deferred revenue for programs not yet telecast	—	92,000	92,000	43,000
Current portion of long-term debt	<u>(50,000)</u>	<u>—</u>	<u>(50,000)</u>	<u>—</u>
	<u>23,000</u>	<u>92,000</u>	<u>115,000</u>	<u>75,000</u>
	<u>\$204,000</u>	<u>—</u>	<u>\$204,000</u>	<u>\$215,000</u>

EXHIBIT 8D

Sample Public Broadcasting Station
Notes to Financial Statements*
December 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type or organization.)

Programs Not Yet Telecast

Costs incurred for programs not yet telecast relate to programs that will be aired principally in the next fiscal year. Grants and contributions relating to programs not yet telecast are included as deferred revenue. As the programs are telecast, the costs incurred will be included in operating expenses and the deferred revenue will be included in revenue.

Note 2—Grants

Note 3—Property and Equipment

Note 4—Long-Term Debt

Note 5—Lease Commitments

Note 6—Retirement Plans

Note 7—Changes in Restricted Deferred Revenue

Note 8—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 9—RELIGIOUS ORGANIZATION

EXHIBIT 9A
Sample Religious Organization
Balance Sheet
December 31, 19X1

	Expendable Funds			Nonexpendable Funds				Total All Funds
	Operating	Deposit and Loan	Total	Plant Fund	Endowment	Annuity and Life Income		
Assets								
Cash	\$1,750,000	\$ 10,000	\$ 1,760,000	\$ 408,000	\$ 20,000	\$ 2,000		\$ 2,190,000
Accounts receivable, less allowance for doubtful receivables of \$12,000	520,000	—	520,000	—	—	—		520,000
Pledges receivable, less allowance for doubtful pledges of \$25,000	500,000	—	500,000	80,000	—	—		580,000
Investments (Note 2)	3,800,000	300,000	4,100,000	260,000	1,300,000	178,000		5,838,000
Loans receivable, less allowance for doubtful loans of \$350,000	—	2,600,000	2,600,000	—	—	—		2,600,000
Advances to plant funds	—	3,500,000	3,500,000	—	—	—		— *
Land, buildings, and equipment at cost, less accumulated depreciation of \$23,500,000 (Note 3)	—	—	—	44,800,000	—	—		44,800,000
Other assets	150,000	—	150,000	—	—	—		150,000
Total assets	\$6,720,000	\$6,410,000	\$13,130,000	\$45,548,000	\$1,320,000	\$180,000		\$56,678,000

18,665

*Interfund borrowings eliminated in combination

Statements of Position

EXHIBIT 9B
Sample Religious Organization
Statement of Support and Revenue, Expenses,
Capital Additions, and Changes in Fund Balances
Year Ended December 31, 19X1

	Expendable Funds			Plant Fund	Nonexpendable Endowment Funds	Total All Funds
	Unrestricted	Operating Restricted	Deposit and Loan			
Support and revenue						
Contributions and bequests	\$ 6,800,000	\$180,000	—	—	—	\$ 6,980,000
Fees for services	4,000,000	—	—	—	—	4,000,000
Endowment and other investment income	200,000	40,000	—	—	—	240,000
Net gain on investment transactions	250,000	—	—	—	—	250,000
Contributed services	950,000	—	—	—	—	950,000
Auxiliary activities	205,000	—	\$535,000	—	—	740,000
Total support and revenue	12,405,000	220,000	535,000	—	—	13,160,000
Expenses						
Program services						
Pastoral	3,300,000	45,000	—	\$ 300,000	—	3,645,000
Education	4,000,000	80,000	—	460,000	—	4,540,000
Health care	2,800,000	25,000	—	250,000	—	3,075,000
Social services	900,000	50,000	—	85,000	—	1,035,000
Cemeteries	220,000	20,000	—	20,000	—	260,000
Religious personnel development	600,000	—	—	55,000	—	655,000
Auxiliary activities	160,000	—	685,000	5,000	—	850,000
Total program services	11,980,000	220,000	685,000	1,175,000	—	14,060,000

18,667

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Statements of Position

EXHIBIT 9C
Sample Religious Organization
Statement of Changes in Financial Position
Year Ended December 31, 19X1

	Expendable Funds			Plant Fund	Nonexpendable Funds		
	Operating	Deposit and Loan	Total		Endowment	Annuity and Life Income	Total All Funds
Resources provided							
Excess (deficiency) of support and revenue over expenses before capital additions	\$ 125,000	\$(150,000)	\$ (25,000)	\$(1,200,000)	—	—	\$(1,225,000)
Capital additions	—	—	—	310,000	\$200,000	—	510,000
Contributions and bequests	—	—	—	15,000	—	—	15,000
Investment income	—	—	—	—	80,000	—	80,000
Net gain on investment transactions							
Excess (deficiency) of support and revenue over expenses after capital additions	125,000	(150,000)	(25,000)	(875,000)	280,000	—	(620,000)
Items that do not use (provide) resources							
Provision for depreciation	—	—	—	1,200,000	—	—	1,200,000
Net gain on investment transactions	(250,000)	(15,000)	(265,000)	—	(80,000)	\$(12,000)	(357,000)
Issuance of long-term debt	—	—	—	400,000	—	—	400,000
Increase in deferred amounts	650,000	—	650,000	3,000	—	2,000	655,000
Proceeds from sale of investments	1,800,000	210,000	2,010,000	332,000	590,000	49,000	2,981,000
Total resources provided	2,325,000	45,000	2,370,000	1,060,000	790,000	39,000	4,259,000

Resources provided
Excess (deficiency) of support and revenue over expenses before capital additions
Capital additions
Contributions and bequests
Investment income
Net gain on investment transactions
Excess (deficiency) of support and revenue over expenses after capital additions
Items that do not use (provide) resources
Provision for depreciation
Net gain on investment transactions
Issuance of long-term debt
Increase in deferred amounts
Proceeds from sale of investments
Total resources provided

EXHIBIT 9D

Sample Religious Organization**Notes to Financial Statements*****December 31, 19X1****Note 1—Summary of Significant Accounting Policies**

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Basis of Presentation

The accompanying financial statements include the assets, liabilities, fund balances, and financial activities of all institutions and organizations providing services at the level of administration above the individual congregation. All significant balances and transactions among the organizations included in the financial statements have been eliminated.

Other Matters

Support arising from contributed services of certain religious personnel has been recognized in the accompanying financial statements. The computation of the value of the contribution of those services represents the difference between the stipends and other amounts paid to or on behalf of the religious personnel and the comparable compensation that would be paid to lay persons if lay persons were to occupy those positions. No computation is made for positions that can be held only by religious personnel.

Note 2—Investments**Note 3—Plant Assets and Depreciation****Note 4—Long-Term Debt****Note 5—Pension Plans****Note 6—Changes in Deferred Restricted Amounts****Note 7—Functional Allocation of Expenses****Note 8—Commitment**

The organization has a lease for certain office facilities that expires December 31, 19X9. The lease contains operating expense and real estate tax escalation clauses. The minimum rental commitment on the lease as of December 31, 19X1, aggregates approximately \$210,000 with annual payments ranging from \$25,000 to \$35,000. Rent expense for the year ended December 31, 19X1, amounted to \$28,000.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 10A

Balance Sheet

June 30, 19X1, and 19X0

Assets		19X1	19X0	Liabilities and Fund Balance		19X1	19X0
Current assets							
Cash		\$ 125,000	\$ 115,000	Current liabilities		\$ 418,000	\$ 388,000
Certificates of deposit		200,000	210,000	Accounts payable and accrued expenses		261,000	210,000
Accounts receivable		372,000	346,000	Restricted grant advances (Note 2)		88,000	82,000
Unbilled contract revenues and reimbursable grant expenses		488,000	390,000	Obligations under capital leases (Note 4)		767,000	680,000
Prepaid expenses and other current assets		40,000	38,000	Total current liabilities		309,000	397,000
Total current assets		1,225,000	1,099,000	Noncurrent capital lease obligations (Note 4)		1,076,000	1,077,000
Property, plant, and equipment (Notes 1 and 4)							
Land and building		220,000	220,000	Fund balance			
Furniture and equipment		167,000	156,000	Unrestricted		458,000	419,000
Leased property under capital leases		479,000	479,000	Net equity in fixed assets		298,000	273,000
		866,000	855,000	Total fund balance		756,000	692,000
Less—accumulated depreciation and amortization		259,000	185,000			\$1,832,000	\$1,769,000
		607,000	670,000				
		\$1,832,000	\$1,769,000				

Statements of Position

EXHIBIT 10B

Sample Research and Scientific Organization**Statement of Revenues, Expenses, and
Changes in Fund Balance****Years Ended June 30, 19X1, and 19X0**

	<u>19X1</u>	<u>19X0</u>
Revenues (Notes 1, 2, and 3)		
Contract revenues—U S government	\$ 5,958,000	\$5,578,000
Restricted grants—foundations and individuals	4,752,000	4,172,000
Other, including interest	43,000	41,000
	<u>10,753,000</u>	<u>9,791,000</u>
Expenses		
Research and development		
Environmental	5,263,000	4,997,000
Health	2,992,000	2,766,000
National defense	1,166,000	938,000
Management and general	1,103,000	985,000
Contract and grant procurement	165,000	151,000
	<u>10,689,000</u>	<u>9,837,000</u>
Excess (deficiency) of revenues over expenses	64,000	(46,000)
Fund balance, beginning of year	<u>692,000</u>	<u>738,000</u>
Fund balance, end of year	<u>\$ 756,000</u>	<u>\$ 692,000</u>

EXHIBIT 10C

Sample Research and Scientific Organization

Statement of Changes in Financial Position

Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Financial resources were provided by		
Excess (deficiency) of revenues over expenses	\$ 64,000	\$ (46,000)
Add—expenses not requiring current outlay of working capital— depreciation and amortization	<u>74,000</u>	<u>26,000</u>
Working capital provided by (used in) operations	138,000	(20,000)
Financing of fixed asset additions through capital leases	<u>—</u>	<u>397,000</u>
Total resources provided	<u>138,000</u>	<u>377,000</u>
Financial resources were used for		
Acquisition of property, plant, and equipment	11,000	481,000
Reduction of noncurrent capital lease obligations	<u>88,000</u>	<u>—</u>
Total resources used	<u>99,000</u>	<u>481,000</u>
Increase (decrease) in working capital	<u>\$ 39,000</u>	<u>\$(104,000)</u>
Changes in working capital were represented by		
Increase (decrease) in current assets—		
Cash	\$ 10,000	\$ (14,000)
Certificates of deposit	(10,000)	(40,000)
Accounts receivable	26,000	10,000
Unbilled contract revenues and reimbursable grant expenses	98,000	42,000
Other	<u>2,000</u>	<u>(1,000)</u>
	<u>126,000</u>	<u>(3,000)</u>
(Increase) decrease in current liabilities—		
Accounts payable and accrued expenses	(30,000)	(23,000)
Restricted grant advances	(51,000)	4,000
Obligations under capital leases	<u>(6,000)</u>	<u>(82,000)</u>
	<u>(87,000)</u>	<u>(101,000)</u>
Increase (decrease) in working capital	<u>\$ 39,000</u>	<u>\$(104,000)</u>

EXHIBIT 10D

Sample Research and Scientific Organization

Notes to Financial Statements*

June 30, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Revenue Recognition

Substantially all of the organization's revenue is derived from restricted grants and cost-plus-fixed-fee contracts. Revenue is recognized based on the proportion of project expenses incurred to total anticipated project expenses (percentage-of-completion method). Losses on contracts are recognized when identified

Note 2—Restricted Grants

Note 3—Government Contracts

Certain contract costs billed to the U.S. government are subject to audit by the Defense Contract Audit Agency. The agency has audited costs billed before July 1, 19X0.

Note 4—Lease Commitments

The organization uses data processing equipment under capital leases expiring in 19X7 which provide for the transfer of ownership of the equipment at the end of the lease term. The related future minimum lease payments as of June 30, 19X1, are as follows:

19X2	\$ 94,000
19X3	94,000
19X4	94,000
19X5	94,000
19X6	94,000
19X7	<u>10,000</u>
	480,000
Less—amount representing interest	<u>(83,000)</u>
Present value of minimum lease payments	<u><u>\$397,000</u></u>

Note 5—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.139

EXHIBIT 11—TRADE ASSOCIATION

EXHIBIT 11A
Sample Trade Association
Balance Sheet
June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Assets		
Current assets		
Cash	\$ 15,000	\$ 24,000
Marketable securities, at market (Note 2)	433,000	330,000
Accounts receivable, net of allowance for doubtful accounts of \$6,000 in 19X1 and \$8,000 in 19X0	51,000	67,000
Publications inventory, at lower of cost (FIFO) or market	<u>122,000</u>	<u>80,000</u>
Total current assets	621,000	501,000
Long-term investments, at market (Note 2)	240,000	250,000
Fixed assets, at cost, net of accumulated depreciation of \$45,000 in 19X1 and \$26,000 in 19X0 (Note 1)	66,000	60,000
Other assets	<u>56,000</u>	<u>46,000</u>
Total assets	<u><u>\$983,000</u></u>	<u><u>\$857,000</u></u>
Liabilities and Fund Balance		
Current liabilities		
Accounts payable and accrued expenses	\$ 96,000	\$ 41,000
Deferred membership dues (Note 1)	<u>262,000</u>	<u>245,000</u>
Total current liabilities	358,000	286,000
Fund balance	<u>625,000</u>	<u>571,000</u>
Total liabilities and fund balance	<u><u>\$983,000</u></u>	<u><u>\$857,000</u></u>

Statements of Position

EXHIBIT 11B

Sample Trade Association**Statement of Revenue, Expenses, and Changes in Fund Balance****Years Ended June 30, 19X1, and 19X0**

	<u>19X1</u>	<u>19X0</u>
Revenue		
Membership dues (Note 1)	\$ 369,000	\$ 279,000
Conferences and meetings	642,000	601,000
Publication sales and advertising	285,000	275,000
Special assessments	101,000	95,000
Investment income including net gains on investments	<u>21,000</u>	<u>23,000</u>
Total revenue	<u>1,418,000</u>	<u>1,273,000</u>
Expenses (Note 5)		
Member services	113,000	109,000
Conferences and meetings	335,000	334,000
Technical services	437,000	472,000
Communications, including publication of magazine	<u>122,000</u>	<u>72,000</u>
Total program expenses	1,007,000	987,000
General administration	308,000	219,000
Membership development	<u>49,000</u>	<u>38,000</u>
Total expenses	<u>1,364,000</u>	<u>1,244,000</u>
Excess of revenue over expenses	54,000	29,000
Fund balance, beginning of year	<u>571,000</u>	<u>542,000</u>
Fund balance, end of year	<u>\$ 625,000</u>	<u>\$ 571,000</u>

EXHIBIT 11C

Sample Trade Association
Statement of Changes in Financial Position
Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Funds were provided by		
Excess of revenue over expenses	\$ 54,000	\$29,000
Add item not requiring funds—depreciation	<u>19,000</u>	<u>12,000</u>
Funds provided by operations	73,000	41,000
Sale of long-term investments	<u>10,000</u>	<u>—</u>
Total funds provided	<u>83,000</u>	<u>41,000</u>
Funds were used for		
Purchase of fixed assets	(25,000)	—
Increase in other assets	<u>(10,000)</u>	<u>(25,000)</u>
Total funds used	<u>(35,000)</u>	<u>(25,000)</u>
Increase in working capital	<u>\$ 48,000</u>	<u>\$16,000</u>
Analysis of changes in working capital		
Increase (decrease) in current assets		
Cash	\$ (9,000)	\$17,000
Marketable securities	103,000	21,000
Accounts receivable	(16,000)	(8,000)
Publications inventory	<u>42,000</u>	<u>16,000</u>
	<u>120,000</u>	<u>46,000</u>
Decrease (increase) in current liabilities		
Accounts payable and accrued expenses	(55,000)	(17,000)
Deferred membership dues	<u>(17,000)</u>	<u>(13,000)</u>
	<u>(72,000)</u>	<u>(30,000)</u>
	<u>\$ 48,000</u>	<u>\$16,000</u>

EXHIBIT 11D

Sample Trade Association
Notes to Financial Statements*
June 30, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies**Note 2—Investments****Note 3—Pension Plan****Note 4—Lease Agreements/Commitments****Note 5—Functional Allocation of Expenses**

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 12—UNION

EXHIBIT 12A
Sample Union
Balance Sheet
December 31, 19X1
(With Comparative Totals for 19X0)

.140

Assets

Current assets
Cash (including savings accounts of \$2,100,000 and \$1,050,000) (Note 3)
Investments at market
Per capita dues receivable
Accrued interest receivable
Loans to affiliated organizations (Note 4)
Accounts receivable (less allowance for doubtful accounts of \$2,300 and \$2,500)
Prepaid expenses
Total current assets

	General Fund (Undesignated)	Strike Insurance Fund (Designated)	December 31, 19X1 Total	December 31, 19X0 Total
	\$ 650,800	\$ 1,710,000	\$ 2,360,800	\$ 1,238,100
	491,800	9,054,200	9,546,000	9,640,400
	51,800	133,200	185,000	189,500
	1,800	210,700	212,500	214,600
	21,400	—	21,400	27,300
	67,900	—	67,900	68,900
	74,900	—	74,900	71,500
	1,360,400	11,108,100	12,468,500	11,450,300

Property, furniture, and equipment at cost (Note 1)			
Land	678,400	678,400	678,400
Buildings (net of accumulated depreciation of \$743,500 and \$675,600)	1,973,400	1,973,400	1,515,500
Furniture and equipment (net of accumulated depreciation of \$314,800 and \$278,200)	50,800	50,800	87,400
Total property, furniture, and equipment	2,702,600	2,702,600	2,281,300
Total assets	<u>\$4,063,000</u>	<u>\$15,171,100</u>	<u>\$13,731,600</u>
Liabilities and Fund Balances			
Current liabilities			
Accounts payable	\$ 337,600	\$ 337,600	\$ 423,100
Notes payable	13,100	13,100	19,600
Affiliation dues payable	48,800	48,800	49,600
Accrued salaries	31,500	31,500	33,000
Payroll taxes and employee deductions payable	89,300	89,300	90,400
Total current liabilities	520,300	520,300	615,700
Fund balances	3,542,700	14,650,800	13,115,900
Total liabilities and fund balances	<u>\$4,063,000</u>	<u>\$15,171,100</u>	<u>\$13,731,600</u>

EXHIBIT 12B
Sample Union
Statement of Revenue, Expense, and Changes in Fund Balances
Year Ended December 31, 19X1
(With Comparative Totals for 19X0)

Revenue
Per capita dues (Note 2)
Initiation fees
Sales of organizational supplies
Rental income
Administrative fees—apprentice training
Interest income
Total revenue

	General Fund (Undesignated)	Strike Insurance Fund (Designated)	December 31, 19X1 Total	December 31, 19X0 Total
	\$9,385,500	\$ 3,532,300	\$12,917,800	\$13,219,800
	24,100	—	24,100	22,800
	26,700	—	26,700	17,900
	216,300	—	216,300	216,100
	11,800	—	11,800	12,100
	28,100	609,000	637,100	644,100
	9,692,500	4,141,300	13,833,800	14,132,800

Expense (Note 6)				
Program services				
Strike assistance to local unions	877,900	2,630,500	3,508,400	3,345,600
Constitutional convention	154,600	—	154,600	132,800
Field office services				
Organization	2,054,000	—	2,054,000	2,106,500
Negotiation	2,156,700	—	2,156,700	2,212,000
Grievance	924,300	—	924,300	947,900
Total program services	6,167,500	2,630,500	8,798,000	8,744,800
Administrative and general	3,537,700	57,600	3,595,300	1,425,200
Net (gains) losses on investments	(94,400)	—	(94,400)	2,062,800
Total expense	9,610,800	2,688,100	12,298,900	12,232,800
Excess of revenue over expense	81,700	1,453,200	1,534,900	1,900,000
Fund balances, beginning of year	3,461,000	9,654,900	13,115,900	11,215,900
Fund balances, end of year	\$3,542,700	\$11,108,100	\$14,650,800	\$13,115,900

Statements of Position

EXHIBIT 12C
Sample Union
Statement of Changes in Financial Position
Year Ended December 31, 19X1
(With Comparative Totals for 19X0)

	General Fund (Undesignated)	Strike Insurance Fund (Designated)	December 31, 19X1 Total	December 31, 19X0 Total
Sources of working capital				
Excess of revenue over expense	\$ 81,700	\$1,453,200	\$1,534,900	\$1,900,000
Add charges not affecting working capital				
Depreciation	104,500	—	104,500	100,300
Working capital provided	186,200	1,453,200	1,639,400	2,000,300
Use of working capital				
Purchase of property, furniture, and equipment	525,800	—	525,800	352,000
Increase (decrease) in working capital	<u>\$ (339,600)</u>	<u>\$1,453,200</u>	<u>\$1,113,600</u>	<u>\$1,648,300</u>

Changes in working capital				
Increase (decrease) in current assets				
Cash		\$1,536,600	\$1,122,700	\$ 186,300
Investments	\$(413,900)	(78,500)	(94,400)	1,425,200
Per capita dues receivable	(15,900)	(3,200)	(4,500)	(2,300)
Accrued interest receivable	(1,300)	(1,700)	(2,100)	(1,200)
Loans to affiliated organizations	(400)	—	(5,900)	(2,600)
Accounts receivable	(5,900)	—	(1,000)	(100)
Prepaid expenses	(1,000)	—	3,400	2,900
	<u>3,400</u>	<u>1,453,200</u>	<u>1,018,200</u>	<u>1,608,200</u>
	\$(435,000)			
Increase (decrease) in current liabilities				
Accounts payable	(85,500)	—	(85,500)	(32,200)
Notes payable	(6,500)	—	(6,500)	(6,500)
Affiliation dues payable	(800)	—	(800)	(200)
Accrued salaries	(1,500)	—	(1,500)	(800)
Payroll taxes and employee deductions payable	(1,100)	—	(1,100)	(400)
	<u>(95,400)</u>	<u>—</u>	<u>(95,400)</u>	<u>(40,100)</u>
Increase (decrease) in working capital	<u>\$(339,600)</u>	<u>\$1,453,200</u>	<u>\$1,113,600</u>	<u>\$1,648,300</u>

EXHIBIT 12D

Sample Union**Notes to Financial Statements*****December 31, 19X1, and 19X0****Note 1—Summary of Significant Accounting Policies****Note 2—Strike Insurance Fund**

In accordance with the provisions of the Union Constitution, 27 percent of the per capita dues paid to the Union are designated for the Strike Insurance Fund. The fund may be distributed for strike relief at the discretion of the Union Executive Board. No charges may be made against the fund for administrative expenses.

Note 3—Pledged Assets and Contingent Liabilities

The Union is contingently liable as guarantor of a loan of \$15,000 to an affiliated local. In connection with the guarantee, a savings account, having a balance of \$20,000, is pledged as collateral for the loan.

Note 4—Loans to Affiliated Organizations

The loans to affiliated organizations represent short-term loans to local unions at current interest rates. All such loans are expected to be collected within one year.

Note 5—Pension Plan**Note 6—Functional Allocation of Expenses**

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.141 EXHIBIT 13—ZOOLOGICAL AND BOTANICAL SOCIETY

EXHIBIT 13A

Sample Zoological and Botanical Society
Balance Sheet
December 31, 19X1

	<i>Operating Funds</i>	<i>Plant Fund</i>	<i>Endowment Funds</i>	<i>Total All Funds</i>
Assets				
Cash	\$ 257,000	\$ 20,000	\$ 50,000	\$ 327,000
Accounts receivable, less allowance for doubtful receivables of \$18,000	125,000	—	—	125,000
Pledges receivable, less allowance for doubtful pledges of \$95,000	520,000	120,000	—	640,000
Inventories, at lower of cost (FIFO) or market	330,000	—	—	330,000
Investments (Note 2)	7,800,000	3,000,000	2,800,000	13,600,000
Land, buildings, and equipment, at cost or fair value at date of gift, less accumu- lated depreciation of \$10,500,000 (Note 3)	—	23,000,000	—	23,000,000
Other assets	180,000	—	—	180,000
Collections (Note 9)	—	—	—	—
Total assets	<u>\$9,212,000</u>	<u>\$26,140,000</u>	<u>\$2,850,000</u>	<u>\$38,202,000</u>
Liabilities and Fund Balances				
Accounts payable and accrued expenses	\$ 350,000	\$ 225,000	—	\$ 575,000
Deferred amounts (Note 6)				
Unrestricted	50,000	—	—	50,000
Restricted	1,600,000	2,915,000	—	4,515,000
Long-term debt (Note 4)	—	900,000	—	900,000
Total liabilities	<u>2,000,000</u>	<u>4,040,000</u>	<u>—</u>	<u>6,040,000</u>
Fund balances				
Unrestricted				
Designated by the governing board for long-term investment	6,200,000	—	—	6,200,000
Undesignated	1,012,000	—	—	1,012,000
	7,212,000	—	—	7,212,000
Restricted—nonexpendable	—	—	\$2,850,000	2,850,000
Net investment in plant	—	22,100,000	—	22,100,000
Total fund balances	<u>7,212,000</u>	<u>22,100,000</u>	<u>2,850,000</u>	<u>32,162,000</u>
Total liabilities and fund balances	<u>\$9,212,000</u>	<u>\$26,140,000</u>	<u>\$2,850,000</u>	<u>\$38,202,000</u>

EXHIBIT 13B
Sample Zoological and Botanical Society
Statement of Support and Revenue, Expenses,
Capital Additions, and Changes in Fund Balances
Year Ended December 31, 19X1

	Operating Funds		Total	Plant Funds	Endowment Funds	Total All Funds
	Unrestricted	Restricted				
Support and revenue						
Contributions and bequests	\$ 550,000	\$1,045,000	\$1,595,000	—	—	\$ 1,595,000
Fees and grants from governmental agencies	—	1,200,000	1,200,000	—	—	1,200,000
Admission charges	1,300,000	—	1,300,000	—	—	1,300,000
Membership dues	350,000	—	350,000	—	—	350,000
Endowment and other investment income	420,000	90,000	510,000	—	—	510,000
Net gain realized on investments	180,000	15,000	195,000	—	—	195,000
Auxiliary activities	3,000,000	—	3,000,000	—	—	3,000,000
Total support and revenue	5,800,000	2,350,000	8,150,000	—	—	8,150,000
Expenses						
Program services						
Animal collections and exhibits	2,742,000	1,825,000	4,567,000	\$ 440,000	—	5,007,000
Educational activities	350,000	135,000	485,000	42,000	—	527,000
Conservation and public service	60,000	90,000	150,000	14,000	—	164,000
Research activities	220,000	300,000	520,000	50,000	—	570,000
Membership activities	78,000	—	78,000	6,000	—	84,000
Auxiliary activities	1,800,000	—	1,800,000	216,000	—	2,016,000
Total program services	5,250,000	2,350,000	7,600,000	768,000	—	8,368,000

**Accounting Principles and Reporting Practices for
Certain Nonprofit Organizations**

18,687

Supporting services	530,000	—	530,000	24,000	—	554,000
General administration	80,000	—	80,000	8,000	—	88,000
Fund raising	610,000	—	610,000	32,000	—	642,000
Total supporting services	5,860,000	2,350,000	8,210,000	800,000	—	9,010,000
Total expenses	(60,000)	—	(60,000)	(800,000)	—	(860,000)
Excess (deficiency) of support and revenue over expenses before capital additions						
Capital additions						
Contributions and bequests	—	—	—	1,030,000	\$ 20,000	1,050,000
Investment income	—	—	—	150,000	—	150,000
Net gain realized on investments	—	—	—	100,000	110,000	210,000
Total capital additions	—	—	—	1,280,000	130,000	1,410,000
Excess (deficiency) of support and revenue over expenses after capital additions	(60,000)	—	(60,000)	480,000	130,000	550,000
Fund balances at beginning of year	7,428,000	—	7,428,000	21,384,000	2,800,000	31,612,000
Transfers						
Equipment acquisitions and principal debt service payments	(236,000)	—	(236,000)	236,000	—	—
Realized gains on endowment funds utilized	80,000	—	80,000	—	(80,000)	—
Fund balances at end of year	\$7,212,000	—	\$7,212,000	\$22,100,000	\$2,850,000	\$32,162,000

Statements of Position

EXHIBIT 13C

Sample Zoological and Botanical Society**Statement of Changes in Financial Position****Year Ended December 31, 19X1**

	<i>Operating Funds</i>	<i>Plant Fund</i>	<i>Endowment Funds</i>	<i>Total All Funds</i>
Resources provided				
Excess (deficiency) of support and revenue over expenses before capital additions	\$ (60,000)	\$ (800,000)	—	\$ (860,000)
Capital additions				
Contributions and bequests	—	1,030,000	\$ 20,000	1,050,000
Investment income	—	150,000	—	150,000
Net gain realized on investments	—	100,000	110,000	210,000
Excess (deficiency) of support and revenue over expenses after capital additions	(60,000)	480,000	130,000	550,000
Items that do not use (provide) resources				
Provision for depreciation	—	800,000	—	800,000
Net gain realized on investments	(195,000)	(100,000)	(110,000)	(405,000)
Issuance of long-term debt	—	900,000	—	900,000
Increase in deferred amounts	200,000	350,000	—	550,000
Proceeds from sales of investments	3,200,000	1,270,000	900,000	5,370,000
Total resources provided	3,145,000	3,700,000	920,000	7,765,000
Resources used				
Purchases of building and equipment	—	1,480,000	—	1,480,000
Reduction of long-term debt	—	36,000	—	36,000
Purchases of investments	2,861,000	2,372,000	848,000	6,081,000
Increase in accounts and pledges receivable	80,000	30,000	—	110,000
Increase in inventories	8,000	—	—	8,000
Decrease in accounts payable and accrued expenses	10,000	20,000	—	30,000
Total resources used	2,959,000	3,938,000	848,000	7,745,000
Transfers				
Equipment acquisitions and principal debt service payments	(236,000)	236,000	—	—
Realized gains on endowment funds utilized	80,000	—	(80,000)	—
Total transfers	(156,000)	236,000	(80,000)	—
Increase (decrease) in cash	\$ 30,000	\$ (2,000)	\$ (8,000)	\$ 20,000

EXHIBIT 13D

Sample Zoological and Botanical Society
Notes to Financial Statements*
December 31, 19X1

Note 1—Summary of Significant Accounting Policies

Note 2—Investments

Note 3—Plant Assets and Depreciation

Note 4—Long-Term Debt

Note 5—Pension Plan

Note 6—Changes in Deferred Restricted Amounts

Note 7—Functional Allocation of Expenses

Note 8—Commitments

Note 9—Collections

The note should disclose the following:

- a.* Capitalization basis or a statement that collections are not capitalized.
- b.* Policy on accounting for current year's purchased and donated collections.
- c.* The nature and the cost, or contributed value, of current year accessions and the nature of and proceeds from deaccessions.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

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The division gratefully acknowledges the contributions made to the development of this statement of position by Franz Hoge, John McLaughlin, Joseph Nehila, John O'Leary, James Ratliff, Vincent Russo, and Frank Van Morrelgem.

➡ *The next page is 18,705.* ←

Section 10,260

Statement of Position 79-1

Accounting for Municipal Bond Funds

January 15, 1979

[Proposal to the Financial Accounting Standards Board to Amend AICPA Industry Audit Guide, *Audits of Investment Companies*]

NOTE

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 these guides, AICPA subcommittees or task forces 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 subcommittee or task force.

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 such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force 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 subcommittee or task force believes would be in the public interest.

.01 The AICPA Industry Audit Guide (audit guide), *Audits of Investment Companies*, as amended, notes that "changes in the rules, regulations, practices, and procedures of the investment company industry have been frequent and extensive in recent years" and that "further changes are under consideration." A recent development in the investment company industry is the municipal bond fund (or tax-exempt bond fund) in corporate form made possible by the Tax Reform Act of 1976. For the first time, the law allows an investment company organized in corporate form to distribute tax-free income to its shareholders. Before the 1976 Reform Act, two forms of investment companies that specialized in municipal bonds were unit investment trusts and limited partnerships.

.02 A tax-exempt municipal bond fund is an investment company that invests principally in municipal bonds. It may be in the form of a management investment company or a unit investment trust. Municipal bonds are obligations of local governments (such as state, county, and city), and the interest paid on those bonds is exempt from federal income tax. The interest on certain of those bonds may also be exempt from state and local income tax.

.03 This proposed addition to the audit guide presents the committee's views on accounting and reporting matters and other considerations relating to municipal bond funds. While the discussion of taxes and distribution policies refers specifically to municipal bond funds in corporate form, the discussion of valuation and other matters applies to municipal bond funds in corporate form, partnership form, and unit investment trusts.

DEFINITION OF AND MARKET FOR MUNICIPAL BONDS AND NOTES

Municipal Bonds

.04 Municipal bonds are usually issued to obtain funds for a variety of public purposes, including the construction of a wide range of public facilities such as airports, bridges, highways, housing, hospitals, mass transportation, schools, streets, and water and sewer works. Municipal bonds may also be issued to refund outstanding obligations, obtain funds for general operating expenses, and obtain funds to lend to other public institutions and facilities.

.05 Industrial development bonds are issued by or on behalf of public authorities to obtain funds to finance privately operated industrial or commercial facilities. These obligations may be classified as municipal bonds, provided that the interest paid on them is exempt from federal income tax.¹

.06 The two principal classifications of municipal bonds are general obligation bonds and revenue bonds. General obligation bonds represent the issuer's unqualified pledge, based on its faith, credit, and taxing power, to pay principal and interest when due. Revenue bonds are payable from the revenues derived from a particular class of facilities or from other specific revenue sources. Tax-exempt industrial development bonds are usually revenue bonds and generally do not carry the pledge of the credit of the issuer.

¹ See Internal Revenue Code, section 103.

.07 The yields on municipal bonds depend on a variety of factors, including market conditions, maturity date, and ratings assigned to the issue.

Municipal Notes

.08 Municipal notes generally mature in less than three years. They are usually designated as tax, revenue, or bond anticipation notes because they are redeemable on receipt of anticipated taxes or revenue or on refinancing from the proceeds of municipal bonds. They include short-term tax-exempt project notes issued by public housing or urban renewal agencies of local communities, with payment of principal and interest guaranteed by the United States government.

Market

.09 There are estimated to be more than 40,000 issuers and well over one million issues of municipal bonds, counting each maturity as a separate issue. The bonds are traded in a dealer market in which little published price information exists. As a result, new issues of municipal bonds are usually sold by competitive bids. Subsequent market quotations for municipal bonds may be obtained from dealers in those securities. If there is little trading activity or if a thin market exists, dealer quotations may not indicate the prices at which a municipal bond may be bought or sold.

PORTFOLIO INVESTMENTS

Valuation

.10 In considering the values assigned to municipal bonds, the fund and its auditor should follow the direction given in the audit guide for the valuation of over-the-counter securities:

A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker/dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any one of these policies is considered to be acceptable if *consistently* applied. . . .

Ordinarily, quotations for an over-the-counter security should be obtained from more than one broker/dealer unless available from an established market-maker for that security, and quotations for several days should be reviewed. In all cases, the quotations should be from *unaffiliated persons*. . . .

Where quotations appear questionable, consideration should be given to valuing the security at "fair value as determined in good faith by the board of directors" [emphasis added].²

.11 In addition, the auditor is provided with the following guidance:

In the case of over-the-counter securities for which quotations were not available from published sources, the auditor should consider obtaining quotations as of the valuation date from *more than one independent source*. . . . If the auditor is not fully satisfied with valuation date results, he may wish to obtain further quotations at a subsequent date or dates or consider having the security valued by the board of directors [emphasis added].³

Determining Market Value

.12 A fund may obtain quoted bid and asked prices directly from dealers. If possible, the fund should obtain prices from a dealer who maintains a market for the issue. If this is not possible, quotations should be obtained from more than one dealer. The portfolio should be valued consistently, using either the bid price or the mean between bid and asked prices as described in the fund's prospectus.

.13 A number of funds have engaged bond dealers or other pricing services to value their portfolios for a fee. This service includes obtaining daily quotations from various dealers and selecting those quotations considered to be most indicative of the market value of the issue. A pricing service may but need not be an expert appraiser of municipal bonds, but it must be able to identify those dealers who are market-makers for an issue and in a position to determine value.

.14 The fund's management is responsible for determining values of portfolio securities in accordance with the fund's policies. Accordingly, if an agent is used for this purpose, the fund must be satisfied that control procedures, whether maintained by the fund or by the pricing service, provide reasonable assurance that material pricing errors would be prevented or detected. Such control procedures might include:

- Checks employed by the pricing service in obtaining daily quotations.
- Verifying daily changes of individual securities prices in excess of a stipulated percentage.

² *Audits of Investment Companies* (New York: AICPA, 1977), pp. 34-35.

³ *Audits of Investment Companies*, pp. 46-47.

- Verifying dealer quotations with other dealers on a test basis.

.15 In evaluating internal accounting controls, the auditor might consider obtaining independent quotations from dealers or visiting the pricing service's facilities to review the procedures used in obtaining daily quotations, or both. If the auditor considers the internal accounting control to be weak, he should expand the scope of his work as he deems necessary.

Fair Value and Matrix Pricing Methods

.16 Municipal bonds for which market quotations are not readily available or for which the fund believes market quotations may not be indicative of the market value of the issue should be valued at fair value. Fair value is determined by the board of directors of a management investment company. Fair value is determined by the sponsor or trustee of a unit investment trust, and/or other party having such responsibility under the trust agreement. For those determinations, matrix pricing or pricing based on reliable quotations of similar securities may be used. In determining fair value, the SEC's Codification of Financial Reporting Policies on the subject, especially Secs. 404.03 and 404.04 (ASRs 113 and 118), should be considered.

.17 The auditor should also consult these accounting series releases as well as the audit guide for guidance on reporting on financial statements where a material portion of the securities are valued "in good faith." However, the auditor will usually find that he is able to satisfy himself that the range of possible values of municipal bonds for which reliable quotations are not readily available would not have a significant effect on the fairness of presentation of the financial statements in conformity with generally accepted accounting principles; in which case, he could express an unqualified opinion.

.18 A mathematical technique known as matrix pricing uses market data available for the issue and similar issues without exclusive reliance on quoted market prices in determining securities valuations.⁴ This method, when used by a fund, results in a "fair value" determination. Accordingly, the auditor's pro-

⁴ Matrix pricing uses electronic data processing techniques to determine valuations for normal institutional-size trading units of debt securities without exclusive reliance on quoted prices. The use of data processing techniques enables one to consider factors such as the issue's coupon interest rate, maturity, and rating by a service and those of similar issues for which quoted prices are available to develop a calculation of what the current market yields would be for the issue in question. Those techniques may also consider market indexes and other market data.

cedures for examining value determined by using matrix pricing should be the same as those applied with respect to any other fair values, as discussed in paragraphs .12 through .17, above.

“When Issued” Securities

.19 Municipal bond funds buy securities on a “when issued” basis more often than most other types of funds. A municipal securities underwriter solicits expressions of interest in a proposed issue and sends a “when issued” priced confirmation against which delivery is made at a later date when the terms of the issue are known. The securities will normally begin trading on a “when issued” basis at the time such confirmation is issued and begin trading as if they had been issued a few days before the closing date. For federal income tax purposes, the holding period of the securities does not begin until they are issued.⁵

.20 While securities offerings have been aborted after “when issued” trading begins, these situations are rare. The asset and liability relating to a “when issued” security should be recorded when the priced transaction confirmation is issued, and the investment should be valued thereafter. Because the securities do not earn interest until the settlement date, they should be identified in the financial statements. The same accounting methods should be used for securities purchased under a delayed delivery contract under which the managing underwriter agrees to deliver securities to purchasers at later specified dates.

Portfolio Insurance

.21 A number of municipal bond funds, primarily those organized as unit investment trusts with fixed portfolios, arrange for insurance that guarantees the collection of principal and interest when due. The insurance normally applies to portfolio securities only while they are owned by the fund, and its coverage is not transferable to a purchaser of the security. This arrangement differs from those in which the issuer of the securities acquires the insurance, making the insurance feature an element of the security and transferable on changes in ownership. If the insurance applies to the fund’s portfolio only, it does not have any measurable value in the absence of default of the underlying securities or indications of the probability of such default.

.22 Probability of default may be indicated if the market value of a bond held by the fund declines significantly and the

⁵ I. T. 3721, 1945 C. B. 164, modified by Rev. Rul. 57-29, 1957-1 C. B. 519.

decline appears to be related to the credit worthiness of the issuer. Problems with respect to credit worthiness may be recognized through comparison with market values of similar securities or by a downgrading of credit ratings.

.23 Valuation of bonds that are held in an insured portfolio and that are in default or for which the probability of default is indicated requires a "fair value" determination as described in the audit guide (pages 35-37) and as further discussed in paragraph .16. Among the factors that should be considered in making this "fair value" determination are the terms of the insurance policy, the intention and ability of the fund to hold the bonds until maturity, and the ability of the insurer to perform under the policy in the event of default.

.24 Proceeds of insurance in place of defaulted interest are exempt for federal income tax purposes.⁶

.25 Insured securities that have been valued as provided in paragraph .23 should be identified in the financial statements as being so valued. Disclosure should also be made of the intention of the fund to hold the securities until maturity in order to realize the benefits of the insurance.

Presentation

.26 Municipal securities should be grouped either by state or municipality within the state or by purpose of issue, whichever is more meaningful. This grouping will also satisfy regulation S-X requirements that investments be classified by type of business.

.27 Although not required, bond ratings of the portfolio of investments are often disclosed. If the auditor has not checked the ratings against published sources, they should be identified as unaudited.

.28 The valuation methods used by the fund should be disclosed in the financial statements.

TAX AND OTHER CONSIDERATIONS

Qualification as a Regulated Investment Company

.29 To enjoy the benefits of paying tax-free dividends to shareholders, a municipal bond fund taxable as a corporation

⁶ Rev. Rul. 76-78.

must first qualify as a regulated investment company.⁷ Because the Internal Revenue Code states that gross income excludes tax-exempt income, such a fund must pay particular attention to meeting requirements in the following respects:⁸

- a. Section 851(b)(3) of the code requires that in order to be qualified as a regulated investment company, less than 30 percent of a fund's gross income may be derived from gains (disregarding losses) from the sale or other disposition of securities held for less than three months. Because the amount of taxable income realized by a municipal bond fund is usually a small percentage of its total income, the base used to determine the effect of the three-month test is usually very small. Consequently, a municipal bond fund taxable as a corporation with a small amount of taxable income may lose its right to qualify as a regulated investment company if it realizes any gains from the sale of securities held for less than three months.⁹
- b. If a municipal bond fund realizes taxable income, it is usually a relatively small amount. Nevertheless, 90 percent of that amount as well as 90 percent of tax-exempt income must be distributed. Declaring dividends in proportion to taxable and tax-exempt income may prevent an inadvertent under-distribution of taxable income.¹⁰

.30 Because premiums paid on purchases of obligations of a state, territory, or possession of the United States, or their political subdivisions, must be amortized for federal income tax purposes, most funds have chosen to amortize those premiums for book purposes. Original issue discount on tax-free bonds is generally amortized periodically for book and tax purposes.

.31 Because investment companies carry securities at value, amortization of premium or discount has no effect on net asset value. Amortization of bond premium results in a decrease in interest income with a corresponding increase in unrealized

⁷ Tax-exempt unit investment trusts are not generally organized as associations taxable as corporations for federal income tax purposes. Interest exempt from federal income tax retains that status when distributed to unit holders by such trusts.

⁸ The tax considerations described herein are as of the date of issuance of this statement of position. The reader should determine whether subsequent changes have been effected in the pertinent provisions of the Internal Revenue Code.

⁹ The Revenue Act of 1978 resolved this problem by providing that "gross income" for purposes of the 90 percent and 30 percent tests includes tax-exempt interest. In addition, the act disallows any loss recognized within thirty-one days of the date of purchase of shares in a tax-exempt mutual fund to the extent of any tax-exempt interest dividend received by a shareholder.

¹⁰ See note 9.

appreciation of investments and vice versa for amortization of bond discount. As a result, a policy of amortization may affect net investment income but would not affect total income from investments (net investment income plus realized and unrealized gains and losses). The accounting policy for amortization should be disclosed in the financial statements.

.32 For determining the amortization of premium on tax-exempt securities, the Internal Revenue Service has ruled (Rev. Rul. 60-17) that bond premium in excess of the call price, if any, must first be amortized to the earliest call date and the basis of the bond reduced accordingly. A remaining excess premium over a subsequent call price must be amortized to that subsequent call date. For those purposes, the remaining excess premium at a point in time is the total premium (that is, amount paid in excess of maturity value) reduced by previous amortization to previous call dates. Finally, the portion of the premium equivalent to the difference between the last call price and the maturity value is amortized over the period from the last call date to maturity.

Equalization

.33 Funds that do not declare dividends daily may use equalization accounting, as described in chapter 2 of the audit guide. A municipal bond fund that realizes a significant amount of taxable income (usually interest on investments in short-term securities) should allocate equalization debits and credits between undistributed tax-exempt income and taxable income.

.34 In defining earnings and profits of a municipal bond fund, I. R. C. sec. 852(c) and Treas. Reg. 1.852-5(b) state that "earnings and profits . . . for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year." The result may be taxation of a distribution of income equalization credits as ordinary income, as illustrated below.

	<i>Book Undistributed Income</i>	<i>Tax Basis Earnings and Profits</i>	
		<i>Current</i>	<i>Accumulated</i>
Tax-exempt interest income	\$100,000	\$100,000	\$100,000
Expenses	(16,000) ¹		(16,000)
Income equalization credits (net)	12,000		
Balance	96,000	100,000	84,000
Dividends paid ²			
Exempt-interest dividends	84,000 ³	84,000	84,000
Ordinary dividends	12,000 ⁴	12,000	—
Total dividends	96,000	96,000	84,000
Undistributed income at year end	— ⁵	\$ 4,000	—

¹ Not deductible from current earnings and profits (Treas. Reg. 1.852-5(b)).

² Based on the assumption that the fund's policy is to distribute all its net equalization credits.

³ Exempt-interest dividend = \$84,000 (\$100,000 - \$16,000).

⁴ Distribution in excess of exempt-interest dividend may be taxed as ordinary income (Treas. Reg. 1.852-5(b)).

⁵ Based on the assumption of a dividend payment on the last day of each month. The undistributed balance of current earnings and profits has no federal income tax significance since the fund has distributed its net tax-exempt income (I. R. C., sec. 852).

Distribution Requirements

.35 The Tax Reform Act of 1976 provides that a regulated investment company that meets certain tests in addition to those enumerated above may pass tax-exempt interest through to its shareholders as "exempt-interest dividends."¹¹ A dividend qualifies as an exempt-interest dividend only if—

- At the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the regulated investment company consists of certain tax-exempt government obligations.
- The dividend is designated by the regulated investment company as an exempt-interest dividend in a written notice mailed to its shareholders not later than forty-five days after the close of its taxable year.

.36 If a fund is disqualified from treating distributions as exempt-interest dividends, it may still qualify as a regulated investment company if it meets the other applicable tests.

¹¹ Tax-exempt unit investment trusts are not generally organized as associations taxable as corporations for federal income tax purposes. Interest exempt from federal income tax retains that status when distributed to unit holders by the trusts.

Distribution Policies

.37 Municipal bond funds whose investment policies require that 100 percent of their assets be invested in tax-exempt securities realize only tax-exempt income except for net gains realized on the sale of investments, which are taxable.

.38 In addition to following the requirements prescribed by the code, a municipal bond fund must also consider the tax effect on its shareholders in deciding on its distribution policies. Because gains realized on redemption of capital shares are taxable to the redeeming shareholders, dividends from net investment income are frequently declared daily in order to maximize the amount received by the redeeming shareholder as tax-exempt income. Dividends are usually paid quarterly or monthly, but redeeming shareholders may receive unpaid dividends at the time of redemption.

Allocation of Expenses

.39 The code requires that a municipal bond fund's allowable deductions be allocated between its taxable and tax-exempt income. Capital gains are excluded from this calculation. The only acceptable basis for allocation appears to be the ratio of tax-exempt income to gross investment (tax-exempt plus taxable) income. The required amortization of premium on tax-exempt bonds must be allocated to the tax-exempt income.

TRANSITION

.40 An accounting change to adopt the provisions of this statement of position should be made prospectively. The change should be made in financial statements issued subsequent to the date of this statement of position. Disclosures should be made in the financial statements in the period of change in accordance with paragraph 17 of APB Opinion 20.

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➤ The next page is 18,865. ←

Section 10,330***Statement of Position 81-1
Accounting for Performance of
Construction-Type and Certain
Production-Type Contracts***

July 15, 1981

[Proposal to Financial Accounting Standards Board]**NOTE**

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They 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 and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

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 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 AICPA Industry Audit Guide, *Audits of Government Contractors*, describes units-of-delivery as a modification of the percentage-of-completion method of accounting for contracts.

- *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.

.05 ARB 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 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.¹ 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 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.² 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:

¹This 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).

²Specifications 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.”

- 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 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.³
- Service contracts of health clubs, correspondence schools, and similar consumer-oriented organizations that provide their services to their clients over an extended period.

³The division is preparing a separate statement of position on program accounting, which will provide guidance on the circumstances in which existing and anticipated production-type contracts may be combined for the purpose of accumulating and allocating production costs. [In July 1981, the division decided to terminate the project and to remove the topic from its agenda. Its decision was based primarily on the view that guidance on the use and applicability of program accounting was unnecessary because the method had gained general acceptance for use by only a few large companies in limited circumstances.]

- 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 industries. The recommendations in this statement need not be applied to immaterial items. Two existing AICPA Industry Audit Guides, *Audits of Construction Contractors* and *Audits of Government Contractors*, provide additional guidance on the application of generally accepted accounting principles to the construction industry and to government contracts, respectively. The recommendations in this statement take precedence in those areas. *Audits of Construction Contractors* is being revised concurrently with this statement to conform to its provisions. .

.19 The guidance on contract accounting and financial reporting in *Audits of Government Contractors* is essentially consistent with the recommendations in this statement except that this statement recommends the cumulative catch-up method for accounting for changes in estimates under the percentage-of-completion method of accounting, whereas either the cumulative catch-up method or the reallocation method is acceptable under the guide. Therefore, *Audits of Government Contractors* is amended so that its guidance on accounting for changes in estimates conforms to the recommendations in this statement. Also, 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 Government Contractors*, the guide is amended to incorporate this statement as an appendix. The provisions of that guide should be interpreted and applied in the context of the recommendations in this statement.

.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 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 (trans-

fer 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.⁴ 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.

⁴The 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.

- 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 systems. Regardless of the techniques used, a contractor's estimating procedures should provide reasonable assurance of a continuing ability to produce reasonably dependable estimates.⁵ 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

⁵The 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.

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 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 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 be-

tween 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 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 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:⁶

- 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.

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.

⁶ The division is preparing a separate statement of position on program accounting, which will provide guidance on the circumstances in which existing and anticipated production-type contracts may be combined for the purpose of accumulating and allocating production costs. [In July 1981, the division decided to terminate the project and to remove the topic from its agenda. Its decision was based primarily on the view that guidance on the use and applicability of program accounting was unnecessary because the method had gained general acceptance for use by only a few large companies in limited circumstances.]

- 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 project is ascribed.⁷
- 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).
- 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 evi-

⁷In 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.

dence 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 45, paragraph 4.⁸ Some of the measures are sometimes made and certified by engineers or architects, but manage-

⁸ARB 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

ment 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 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 ac-

cumulated at job sites but that have not been physically installed do not relate to performance.⁹ 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

⁹The 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.

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 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 (esca-

lation), 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.¹⁰ 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 solely 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.

¹⁰Cost-type government contracts with fees based on a percentage of cost are no longer granted under government regulations

.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, site, 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.¹¹ Methods of allocating indirect costs should be systematic and rational. They include, for example, allocations based on direct labor costs, direct 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 accounting¹² or, in some circumstances, as indirect contract costs by government contractors.¹³

¹¹The AICPA industry audit guide, *Audits of Government Contractors*, states, "Practice varies among government contractors as to the extent to which costs are included in inventory. Some contractors include all direct costs and only certain indirect costs. Other contractors record in inventory accounts all costs identified with the contract including allocated 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 45, paragraph 10, may appropriately be extended to government contracts because they believe that "all costs under the contract are directly associated with the contract revenue, and both should be recognized in the same period."

¹²Paragraph 10 of ARB 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.

¹³See the discussion of the AICPA industry audit guide, *Audits of Government Contractors*, in footnote 11.

- 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 in-

curred to complete the existing contract or contracts in progress and are distinguished from research and development costs.¹⁴ 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 pre-contract 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.¹⁵
- 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

¹⁴Statement of Financial Accounting Standards no. 2, *Accounting for Research and Development Costs*, requires that research and development costs be charged to expense when incurred.

¹⁵See footnote 3, which indicates that the division is preparing a statement of position on program accounting for consideration by the FASB.

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. 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.¹⁶

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

¹⁶The 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.

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 20, *Accounting Changes*.¹⁷ 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.

.84 Although estimating is a continuous and normal process for contractors, the second sentence of APB Opinion 20, paragraph 33, recommends disclosure of the effect of significant revisions if the effect is material.¹⁸

¹⁷Paragraph 31 of APB Opinion 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."

¹⁸APB Opinion 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.

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.

Transition

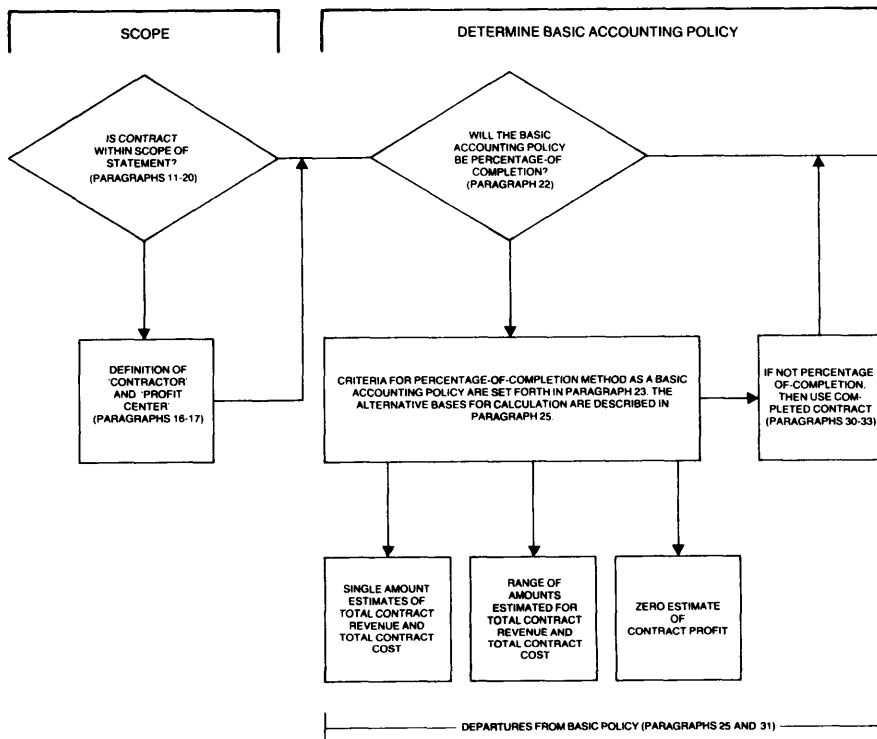
.90 An accounting change from the completed-contract method or from the percentage-of-completion method to conform to the recommendations of this statement of position should be made retroactively by restating the financial statements of prior periods. The restatement should be made on the basis of current 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 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 20, paragraph 28.

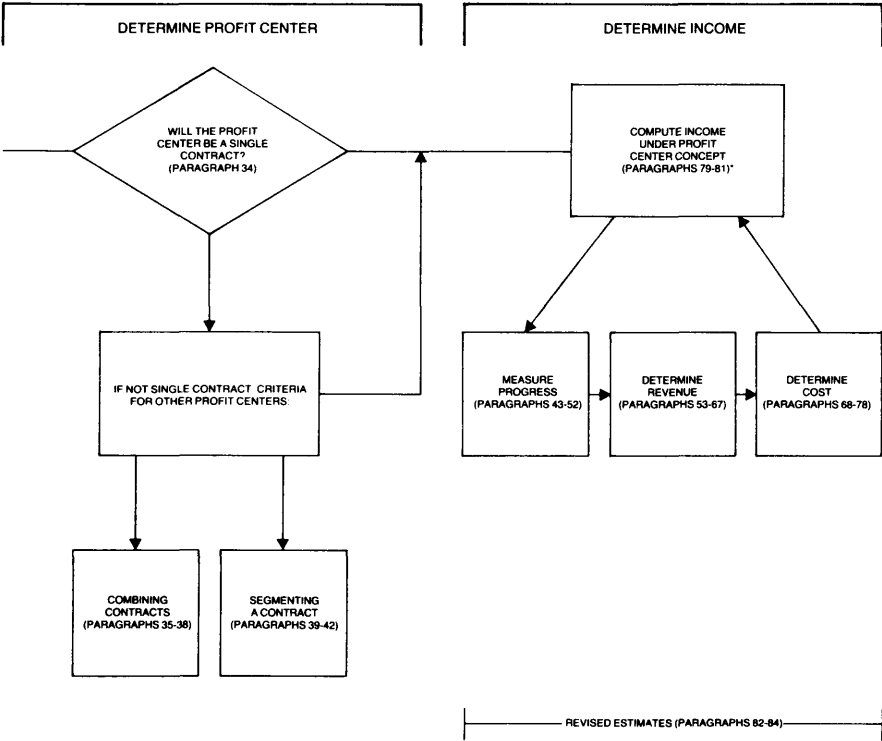
.92

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 85-89



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.¹

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.

¹AICPA Industry Audit Guide, *Audits of Government Contractors* (New York: American Institute of Certified Public Accountants, 1975), pp. 3-4.

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 incentive 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.²

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.

²AICPA Industry Audit Guide, *Audits of Government Contractors*, pp. 4-6.

.94

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 18,921. ←

Section 10,340***Statement of Position 81-2
Reporting Practices Concerning
Hospital-Related Organizations***

August 1, 1981

**[Proposal to the Financial Accounting Standards Board to Amend
AICPA Industry Audit Guide, *Hospital Audit Guide*.]****NOTE**

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 these guides, AICPA committees, subcommittees, or task forces 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, subcommittee, or task force.

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 such matters, members should be aware that they may be called upon to justify departures from the recommendations of the committee, subcommittee, or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee, subcommittee, or task force 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, subcommittee, or task force believes would be in the public interest.

.01 In recent years there has been an increasing trend toward the creation of separate organizations, frequently referred to as foundations, to raise and hold certain funds for hospitals.

.02 Those organizations appear to have been created to broaden the philanthropic base of hospitals and to preserve discretionary funds to support desired programs. There is a growing fear that governmental programs and controls will require the expenditure of such funds to subsidize nondiscretionary services. Organizers of separate fund-raising entities hope that exposure of the funds to such threats may be avoided, or at least lessened, by the use of separate organizations.

.03 Some people believe that the financial statements of the separate organizations should not be combined with those of the related hospitals because combining them would result in a requirement to use contributed discretionary funds to defray a portion of the costs of care for patients who are covered by programs such as Medicare, Medicaid, and Blue Cross. Others share that concern but believe that it should be dealt with independently of accounting considerations and that accounting and reporting should be determined without reference to those potential effects.

.04 There is also concern that, if the form of the combination reflects the unrestricted resources of the related organization as unrestricted resources of the hospital, the difference in the availability of the related organization's resources because of its separate legal status would not be clearly disclosed.

.05 The AICPA's *Hospital Audit Guide* presently calls for combined financial reporting for related organizations "if significant resources or operations of a hospital are handled by such organizations . . . [and they] are under control of (or common control with) hospitals. . . ." However, the guide does not give sufficient guidance about what constitutes "control" or "hospital resources." As a consequence, a variety of reporting practices are being followed, and the financial statements of some related organizations are combined with those of hospitals while the financial statements of other organizations in similar circumstances are not. The related facts and circumstances sometimes are disclosed and sometimes are not.

.06 Because of the variety of current reporting practices, the subcommittee on health care matters believes that the *Hospital Audit Guide* should be clarified in this area.

Subcommittee's Conclusions

.07 The subcommittee on health care matters believes that the section of the *Hospital Audit Guide*, 3d ed. (1980), under "Other Related Organizations" (pages 11 and 12) should be superseded by the following paragraphs.

.08 Foundations, auxiliaries, guilds, and similar organizations frequently assist and, in many instances, are related to hospitals. Accounting Research Bulletin no. 51, *Consolidated Financial Statements*, provides guidance on whether the financial statements of related organizations should be consolidated or combined. Page 3 of the *Hospital Audit Guide* indicates the applicability of Accounting Research Bulletins to hospitals.

.09 Not-for-profit hospitals may be related to one or more separate not-for-profit organizations. For purposes of this statement of position, a separate organization is considered to be related to a hospital¹ if

- a. The hospital controls the separate organization through contracts or other legal documents that provide the hospital with the authority to direct the separate organization's activities, management, and policies; *or*
- b. The hospital is for all practical purposes the sole beneficiary of the organization. The hospital should be considered the organization's sole beneficiary if any one of the three following circumstances exist:
 1. The organization has solicited funds in the name of the hospital, and with the expressed or implied approval of the hospital, and substantially all the funds solicited by the organization were intended by the contributor, or were otherwise required, to be transferred to the hospital or used at its discretion or direction.
 2. The hospital has transferred some of its resources to the organization, and substantially all of the organization's resources are held for the benefit of the hospital.

¹ This paragraph presents criteria for determining whether such an organization is a hospital-related organization for the purposes of this statement of position. SAS No. 6, *Related Party Transactions* [superseded by SAS No. 45, *Omnibus Statement on Auditing Standards—1983*.], discusses the auditor's responsibilities concerning related parties in general.

3. The hospital has assigned certain of its functions (such as the operation of a dormitory) to the organization, which is operating primarily for the benefit of the hospital.

.10 If the condition described in subparagraph .09a and at least one of the conditions described in subparagraph .09b are satisfied, and if the financial statements of the hospital and the related organizations are not consolidated or combined in accordance with paragraph .08, then the hospital's financial statements should disclose information concerning the related organizations. The hospital should present summarized information about the assets, liabilities, results of operations, and changes in fund balances of the related organizations in the notes to the hospital's financial statements and should clearly describe the nature of the relationships between the hospital and the related organizations. (Appendix A illustrates this disclosure.) When a related organization makes its assets available to the hospital, the hospital should account for them in accordance with the terms and conditions prescribed by the related organization.

.11 There may be instances in which the items presented in the financial statements of the related organization are not consolidated, combined, or disclosed in accordance with the requirements of paragraph .10 because they do not meet the conditions described in the preceding paragraphs. If a related organization holds material amounts of funds that have been designated for the benefit of the hospital, or if there have been material transactions between the hospital and the related organization, the hospital's financial statements should disclose the existence and nature of the relationship between the hospital and the related organization. Further, if there have been material transactions between the hospital and the related organization during the periods covered by the hospital's financial statements, the following should also be disclosed:

- a. A description of the transactions, summarized if appropriate, for the period reported on, including amounts, if any, and any other information deemed necessary to an understanding of the effects on the hospital's financial statements.
- b. The dollar volume of transactions and the effects of any change in the terms from the preceding period.
- c. Amounts due from or to the related organization, and, if not otherwise apparent, the terms and manner of settlement.

.12 Appendix B illustrates the foregoing disclosures for a not-for-profit hospital that, during the year, received substantial amounts of contributions from a not-for-profit community health fund-raising organization that is controlled by the hospital but that also raises funds for other health-related organizations in the community. Similar information would also be disclosed in situations in which the hospital does not control the separate organization but is its sole beneficiary, as described in subparagraph .09*b*, and there have been material transactions during the year between the hospital and the separate organization.

Transition

.13 This statement of position should be applied in financial statements for fiscal years beginning on or after July 1, 1981, although earlier application is encouraged. Accounting changes adopted to apply the recommendations of this statement of position should be made retroactively by restating the financial statements of prior periods.

.14

APPENDIX A

Note — Sample Hospital Foundation

Note: Appendix A illustrates the disclosure by a not-for-profit hospital that is considered to be related to a separate not-for-profit organization because the hospital controls it and is deemed to be its sole beneficiary, as described in paragraph .09 of the SOP.

Sample Hospital Foundation (the foundation) was established to raise funds to support the operation of Sample Hospital. The foundation's bylaws provide that all funds raised, except for funds required for operation of the foundation, be distributed to or be held for the benefit of the hospital. The foundation's bylaws also provide the hospital with the authority to direct its activities, management, and policies. The foundation's general funds, which represent the foundation's unrestricted resources, are distributed to the hospital in amounts and in periods determined by the foundation's board of trustees, who may also restrict the use of general funds for hospital plant replacement or expansion or other specific purposes. Plant replacement and expansion funds, specific-purpose funds, and assets obtained from income from endowment funds of the foundation are distributed to

the hospital as required to comply with the purposes specified by donors. A summary of the foundation's assets, liabilities and fund balances, results of operations, and changes in fund balances follows.

	<u>19X1</u>	<u>19X0</u>
	<i>(in thousands)</i>	
Assets	<u>\$11,118</u>	<u>\$10,265</u>
Liabilities ⁽¹⁾	<u>\$ 1,046</u>	<u>\$ 1,025</u>
Fund balances		
Unrestricted	3,525	3,230
Restricted	<u>6,547</u>	<u>6,010</u>
Total fund balances	<u>10,072</u>	<u>9,240</u>
Total liabilities and fund balances	<u>\$11,118</u>	<u>\$10,265</u>

1 Includes \$1 million payable at the end of each year to Sample Hospital. These amounts were paid after the end of each year.

	<u>19X1</u>	<u>19X0</u>
	<i>(in thousands)</i>	
Support and revenue	<u>\$ 4,867</u>	<u>\$ 4,240</u>
Expenses		
Distributions to Sample Hospital ⁽²⁾	4,154	3,112
Other	<u>228</u>	<u>320</u>
Total expenses	<u>4,382</u>	<u>3,432</u>
Excess of support and revenue over expenses	485	808
Other changes in fund balances	347	112
Fund balance, beginning of year	<u>9,240</u>	<u>8,320</u>
Fund balance, end of year	<u>\$10,072</u>	<u>\$ 9,240</u>

2 The distributions by the foundation to Sample Hospital are included in the hospital's financial statements as follows:

	<u>19X1</u>	<u>19X0</u>
	<i>(in thousands)</i>	
Unrestricted grants and contributions	\$1,404	\$ 912
Restricted grants for specific purposes	250	200
Plant replacement and expansion	<u>2,500</u>	<u>2,000</u>
	<u>\$4,154</u>	<u>\$3,112</u>

.15

APPENDIX B

Note — Related-Party Transactions

Note. Appendix B illustrates the disclosure by a not-for-profit hospital that is considered to be related to a separate not-for-profit organization because it controls the separate organization but is not its sole beneficiary, as described in paragraph .09 of the SOP. There were also material transactions between the hospital and the related organization.

Because of the existence of common trustees and other factors, ABC Hospital controls Community Health Foundation (the foundation). The foundation is authorized by ABC Hospital to solicit contributions on its behalf. In its general appeal for contributions to support the community’s providers of health care services, the foundation also solicits contributions for certain other health care institutions. In the absence of donor restrictions, the foundation has discretionary control over the amounts to be distributed to the providers of health care services, the timing of such distributions, and the purposes for which such funds are to be used.

The contributions made by the foundation to the hospital during the year ended December 31, 19X1 and 19X0, are included in the hospital’s financial statements as follows.

	<u>19X1</u>	<u>19X0</u>
Unrestricted contributions	\$150,000	\$150,000
Restricted contributions for		
Specific purposes	35,000	25,000
Plant replacement and expansion purposes	25,000	50,000
Endowment purposes	50,000	150,000

.16

APPENDIX C

Summary of Requirements of the Hospital

<u>Circumstances</u>	<u>Requirements</u>
1. The hospital is related to a separate organization and meets the criteria stated in ARB no. 51.	Consolidate or combine in accordance with ARB no. 51.
2. The hospital does not meet the criteria stated in ARB no. 51 but controls <i>and</i> is the sole beneficiary of the related organization's activities.	In a note to the financial statements, disclose summarized financial data of the related organization, such as total assets, total liabilities, changes in fund balances, total revenue, total expenses, and amount of distributions to the hospital; and disclose the nature of the relationship between the hospital and the related organization.
3. Neither of the above is present, but the related organization holds significant amounts of funds designated for the hospital.	Disclose the existence and nature of the relationship.
4. There have been material transactions between the hospital and the related organization. (This could be present in any of the above circumstances.)	In the notes to the financial statements, (a) disclose the existence and nature of the relationship and (b) describe and quantify the transactions.

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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 Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the Institute's Code of Professional Ethics. However, Statement on Auditing Standards 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by Statement on Auditing Standards 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be aware that they may be called upon to justify departures from the recommendations in this statement of position if their work is challenged.

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.¹

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.
- 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,

¹The 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.

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 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 non-current, 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.² 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.

²Paragraph .27 defines the estimated current amount of a liability

.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 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.³

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

³For further discussion on valuing marketable securities, see the AICPA Industry Audit Guide, *Audits of Investment Companies* (New York: AICPA, 1973) pp. 15-17.

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 estimated 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.⁴ 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.

⁴The 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

- 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.
- 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.⁵

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.

⁵For 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

***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 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 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 5, *Accounting for Contingencies*, and related amendments and interpretations, provide guidance on accounting for contingencies, and FASB Statement 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>	
	<u>19X3</u>	<u>19X2</u>
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><u>\$ 1,384,000</u></u>	<u><u>\$ 1,206,700</u></u>

The notes to financial statements are an integral part of these statements.

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>	
	<u>19X3</u>	<u>19X2</u>
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 on 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><u>\$ 1,013,000</u></u>	<u><u>\$ 921,300</u></u>

The notes to financial statements are an integral part of these 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>shares or</u> <u>bonds</u>	<u>Estimated</u> <u>current</u> <u>values</u>	<u>Number of</u> <u>shares or</u> <u>bonds</u>	<u>Estimated</u> <u>current</u> <u>values</u>
<u>Stocks</u>				
Jaiven Jewels, Inc.	1,500	\$ 98,813		
McRae Motors, Ltd.	800	11,000	600	\$ 4,750
Parker Sisters, Inc.	400	13,875	200	5,200
Rosenfield Rug Co.			1,200	96,000
Rubin Paint Com- pany	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

.35

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.¹

The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases should be disclosed.² 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.

¹The 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.

²Differences between the estimated current amounts of major liabilities or categories of liabilities and their tax bases should also be disclosed.

<i>Description</i>	<i>(A) Estimated current values</i>	<i>(B) Tax bases</i>	<i>Excess of (A) over (B)</i>	<i>Effective income tax rates</i>	<i>Amount of estimated income taxes</i>	<i>Assumptions used</i>
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.	550,000	119,500	430,500	20%	86,100	Long-term capital gain rate.

Vested interest in deferred profit sharing plan	111,400	—	111,400	50%	55,700	Maximum tax rate.
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>\$850,000¹</u>		<u>\$239,000²</u>	

¹The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases should be disclosed.

²This amount should be presented in the statement of financial condition between liabilities and net worth.

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Section 10,360**Statement of Position 83-1
Reporting by Banks Of
Investment Securities
Gains or Losses**

December 31, 1983

[Amendment to AICPA Industry Audit Guide Audits of Banks.]**NOTE**

This statement of position significantly amends the recommendations on accounting principles in the AICPA Industry Audit Guide, *Audits of Banks* (1983), for bank income statements for periods ending on or after December 31, 1983.

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. Statements of position do not establish standards enforceable under rule 203 of the Institute's Code of Professional Ethics. However, Statement on Auditing Standards 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by Statement on Auditing Standards 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

Background

.01 The format of banks' income statements has been periodically reviewed, discussed, and revised by bank regulators, the Securities and Exchange Commission, and the accounting profession during the last sixteen years. Although general agreement has evolved on most issues, the method of reporting realized investment securities gains or losses remains controversial.

.02 The issue was first addressed by the AICPA Committee on Bank Accounting and Auditing in the 1968 audit guide, *Audits of Banks*, which was amended by a supplement in December 1969. The amended guide recommended the following:

- Securities gains or losses less related income tax effects should be reported below "income before securities gains (losses)"; such gains or losses are to be included in the determination of net income.

- Earnings per share may be reported for income before securities gains or losses as well as for net income.

Since 1969, this two-step format has been followed for both regulatory and stockholder reporting purposes.

.03 In April 1977 the SEC proposed, in a revision of Article 9 of Regulation S-X, that the two-step format be eliminated. The AICPA Banking Committee responded positively to this SEC proposal in a letter dated July 1, 1977. However, as a result of a significant number of negative responses from the banking industry, the SEC decided not to adopt the proposal at that time.

.04 For the past several years the AICPA Banking Committee has been preparing a revised *Audits of Banks*. This revised audit guide, issued in February 1983, includes an illustrative income statement using the two-step format for reporting investment securities gains or losses.

.05 In a July 1982 revision of Article 9 of Regulation S-X, the SEC again proposed the elimination of the two-step format. On October 13, 1982, the AICPA Banking Committee responded to the proposal, stating in part:

Although there are substantive arguments for including securities gains or losses as another item of income and not in a separate section of a two-step income statement, we believe this issue should be resolved by the FASB. . . . To assist the FASB in this process, the committee established a special task force to draft a statement of position addressing this issue. . . .

On March 7, 1983, the SEC adopted final rules amending Article 9 of Regulation S-X requiring the use of the one-step format for all bank holding company filings effective for fiscal years ending on or after December 31, 1983, with earlier application permitted.

Rationale for the Two-Step Format

.06 The impetus for the two-step format can be traced back to the income tax law in effect before July 12, 1969. This law provided that if securities transactions in a particular year resulted in a net gain, the gain would be taxed at capital gain rates; a net securities loss would be deductible from ordinary income. Accordingly, banks attempted to realize their gains in "net bond gain years" and their losses in "net bond loss years." Banks argued that including such gains and losses in "operating" earnings would cause reported earnings to fluctuate in an arbitrary, tax-driven manner. The income tax law was amended effective July 12, 1969, resulting in the inclusion of both gains and losses in ordinary income, thus eliminating the potential for such fluctuations.

.07 Proponents of the two-step format argue that including investment gains and losses in operating earnings provides an opportunity

to manage earnings, because the securities sold and the timing of the sales are at the discretion of management. Proponents also fear that banks may be reluctant to absorb losses as a charge against current earnings, although reinvestment of the proceeds at higher yields is in their long-term economic interest.

.08 In connection with the second concern, some proponents believe that changing the reporting format may affect the way funds are invested. For example, bankers might be reluctant to invest in securities with fixed rates of return for extended time periods. Irreparable damage might be done to the market for long-term state and municipal obligations if banks shift funds to shorter term U. S. Treasury bills and other U. S. government obligations.

.09 It is also argued that since the gain or loss generally represents an adjustment of the yield to maturity of the related security, it should be spread over some future period rather than be charged or credited entirely to the current period. This view supports deferral and amortization, which are not acceptable under generally accepted accounting principles. As an alternative, the two-step income statement is considered a more meaningful presentation of short-term operating results (income before securities gains or losses) and longer term results (net income) than the one-step format.

.10 Finally, it is argued that there is no compelling reason to change because the current format has been in use for many years and is well understood by readers of bank financial statements.

Rationale for the One-Step Format

.11 Although investment securities are generally purchased as long-term investments, they may be sold for tax planning, liquidity, or portfolio restructuring purposes. Accordingly, proponents of the one-step format believe that securities gains or losses should be included in operating earnings because they are an integral part of a bank's operations. Proponents also note that the current two-step format presents securities gains or losses in effect as extraordinary items; such gains or losses generally do not meet the extraordinary item classification criteria in Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations*.

.12 Banks report income before securities gains or losses and net income with equal prominence in their income statements. However, the thrust of other reporting—press releases, the chairman's letter to stockholders, management's discussion and analysis of earnings included in financial reports, and newspaper articles—generally emphasizes income before securities gains or losses. As a result, there is concern that banks presently are in a position to manage earnings by realizing losses, reporting them "below the line," and investing the

proceeds at higher yields, thereby reporting improved future earnings "above the line."

.13 Proponents of the one-step format point out that other non-recurring gains or losses from the sale of bank assets are included in operating earnings. In recent years these assets have included equity securities and real estate acquired in satisfaction of loans, main office and branch bank buildings, the residual value of leased assets, and portions of the loan portfolio. The timing of the transactions is somewhat discretionary, similar to that of investment securities transactions. Accordingly, there appears to be little justification for classifying and reporting investment securities transactions separately.

.14 Proponents of the one-step format discount the concern that irreparable damage will be done to the market for long-term state and municipal obligations. They contend that investment decisions are more likely to be based on economic concerns than on accounting results. For example, they believe that the current period of volatile high interest rates has already adversely affected the market for all long-term fixed-rate securities.

.15 Finally, proponents of the one-step format point out that most other types of business enterprises use the one-step approach in reporting their operating results, and they see no continuing theoretical reason to make an exception for banks.

Recommendations of the Banking Committee

.16 The AICPA Banking Committee recommends the following:

- Net investment securities gains or losses should be presented on a separate line, on a pretax basis, in the "other income" section of a bank's income statement. If not material, they may be included in "other income."
- Prior periods' interim and annual financial statements should conform with the one-step format.¹

Rationale for the Recommendations

.17 The committee acknowledges arguments supporting both the two-step and the one-step formats. However, the committee concludes the following:

- Investment securities transactions are an integral part of a bank's operations.

¹As reported in the June 27, 1983, issue of the *CPA Letter*, the AICPA Auditing Standards Division has considered the provisions of this statement and concluded that this change would not affect consistency in the application of generally accepted accounting principles because it has no effect on financial position or net income. Accordingly, the auditor need not modify his opinion regarding consistency of application of accounting principles as a result of this change, assuming disclosure and retroactive application of the change.

- Potential presently exists for realizing losses and reporting them below the line in order to report improved future earnings above the line.
- Nonrecurring gains or losses on the sale of other bank assets are currently reported above the line.
- Some of the original reasons for reporting securities gains or losses below the line are no longer valid. There is little remaining justification for continuing to make an exception for banks in reporting earnings using the two-step income statement format.

Effective Date and Transition

.18 The committee recommends that the provisions of this statement of position should apply to bank income statements issued for periods ending on or after December 31, 1983. Comparative income statements of prior periods should conform with the provisions of this statement of position.

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Section 10,370

***Statement of Position 85-1
Financial Reporting by
Not-for-Profit Health Care
Entities for Tax-Exempt
Debt and Certain Funds
Whose Use Is Limited***

January 1, 1985

[Amendment to AICPA Industry Audit Guide, *Hospital Audit Guide*.]**NOTE**

This statement of position amends the AICPA Industry Audit Guide, *Hospital Audit Guide*.

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. Statements of position do not establish standards enforceable under rule 203 of the Institute's Code of Professional Ethics. However, Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

Introduction and Scope

.01 Increased construction costs of health care facilities, resulting from rising prices and a decline in philanthropy and government grants as sources of capital, have caused health care entities to finance facilities acquisitions, additions, and renovations with long-term debt.

.02 Issuance of tax-exempt or taxable bonds are among the long-term financing alternatives available to health care entities. Approximately three-fourths of all health care entity debt instruments issued in recent years have been tax-exempt bonds, generally revenue bonds. Tax-exempt bonds can usually be issued to obtain a higher ratio of project financing (up to 100 percent), a longer maturity period (up to thirty years), and a lower interest cost than taxable bonds.

.03 Because many hospitals cannot legally issue tax-exempt revenue bonds directly, a significant number of states have enacted legislation permitting health care entities to borrow funds for capital projects by issuing bonds through financing authorities. Financing authorities are authorized to issue tax-exempt bonds or other obligations and use the proceeds for the benefit of the health care entities. To obtain project financing, a health care entity is sometimes required by a financing authority to enter into a lease arrangement or sublease arrangement or both. At other times a lease or sublease arrangement is not required. In either case a liability is recorded in the health care entity's balance sheet.

.04 In the absence of definitive guidance, diverse reporting practices related to funds whose use is limited under those financing arrangements, or under third-party reimbursement arrangements, have developed in the health care industry. The Accounting Standards Division believes that specific guidance is needed to achieve uniform reporting practices for—

- Long-term debt issued through financing authorities for the benefit of health care entities, repayment of which is the entities' responsibility.
- Funds whose use is limited under the terms of debt-financing agreements.
- Investment income earned on funds whose use is limited under debt-financing agreements and the interest expense on the debt.
- Funds whose use is limited under third-party reimbursement arrangements and related investment income.

.05 This statement addresses the reporting of tax-exempt bonds or other tax-exempt obligations issued through financing authorities to finance the facilities of not-for-profit health care entities, which are responsible for repayment of the bonds. It also addresses issues related to the reporting of funds established under the terms of debt-financing instruments and of the investment (interest) income and expense on such funds, neither of which is addressed by the AICPA Industry Audit Guide, *Hospital Audit Guide*.

.06 In addition, this statement modifies the reporting of funds whose use, under third-party reimbursement arrangements, is limited to such purposes as replacements or additions to property, plant, and equipment. Those funds are addressed in the *Hospital Audit Guide*.

Definitions

.07 The following definitions apply for purposes of this statement.

Assets (Funds) Whose Use Is Limited. Assets whose use is limited appear in the general (unrestricted) funds section of the balance sheet and include—

- Assets set aside by the governing board for identified purposes and over which the board retains control and may, at its discretion, subsequently use for other purposes.
- Proceeds of debt issues and funds of the health care entity deposited with a trustee and limited to use in accordance with the requirements of an indenture or similar document.
- Other assets limited to use for identified purposes through an agreement between the health care entity and an outside party other than a donor or grantor.

Donor-Restricted Funds. Funds restricted for specific purposes by donors or grantors, for example, endowment funds or funds restricted to plant replacement and expansion.

General Funds. See paragraphs .08, .09, and .10.

Indenture. An agreement between two or more persons specifying the reciprocal rights and duties of the parties under a contract, such as a lease, mortgage, or contract between bondholders and the issuer of the bond.

Revenue Bonds. Bonds generally issued by a financing authority for the benefit of a health care entity and secured by a pledge of the entity's revenues.

.08 A health care entity's resources and obligations are generally segregated into logical account groups based on external restrictions (restricted funds) or administrative requirements (unrestricted or general funds). Unrestricted funds are used for general operating purposes and reflect those resources or obligations that are not restricted by donors or grantors.

.09 Classifying funds whose use is limited under terms of debt-financing agreements or third-party reimbursement agreements as unrestricted funds is often confusing to readers of a health care enti-

ty's financial statements because the readers may infer that the limitations require the funds to be classified as restricted rather than unrestricted. However, as discussed further in this statement, only funds restricted by a donor or a grantor should be reported as donor-restricted funds; other funds should be reported as general funds.

.10 Although the term "unrestricted funds" has been used historically to identify those funds that are not restricted by donors or grantors, the caption "unrestricted funds" should be changed to "general funds" because this term is more meaningful to readers of financial statements. The term "unrestricted funds" in the *Hospital Audit Guide* should be replaced with the term "general funds" and be defined as follows:

General Funds. Funds not restricted for identified purposes by donors or grantors, including resources that the governing board may use for any designated purpose and resources whose use is limited by agreement between the health care entity and an outside party other than a donor or grantor.

The Basic Issues

.11 Not-for-profit health care entities face the following reporting issues related to tax-exempt debt and funds whose use is limited under a debt-financing agreement or a third-party reimbursement arrangement.

- a. How and when should a health care entity report long-term debt issued for its benefit and for which it is responsible for repayment in full?
- b. Should funds whose use is limited under the terms of an indenture agreement or a third-party reimbursement arrangement be classified on the balance sheet as general (unrestricted) or as restricted funds?
- c. How should related investment income and interest expense be reported in the financial statements?

Issues associated with the accounting for board-designated assets are discussed adequately in the *Hospital Audit Guide*.

Diversity in Practice

.12 When a financing authority issues tax-exempt bonds or similar debt instruments and uses the proceeds for the benefit of a health care entity, some entities report the obligation in the general (unrestricted) funds section of the balance sheet. Others report the obligation in the restricted funds section of the balance sheet.

.13 Reporting practices also differ for funds whose use is limited or for funds that are required by terms of an indenture agreement

to be held by trustees for construction costs, debt service reserve payments, and other costs related to the project. Some entities report those funds as assets of the restricted funds. Others report them as noncurrent assets in the general (unrestricted) funds section of the balance sheet. Others net the assets with the corresponding debt, reporting the net amount either in the general (unrestricted) fund or in the restricted fund and disclosing in a note to the financial statements the amounts the indenture requires to be held by bond trustees for debt service payments and other purposes.

.14 In addition to the variety of asset reporting practices described above, several methods are used to report the related investment income and interest expense in the statement of revenues and expenses. Some entities report investment income and interest expense either in the operating or in the nonoperating revenues and expenses sections. Others report net investment income or expense as either operating or nonoperating revenue or operating or nonoperating expense. If the assets have been reported as restricted funds, others report the related investment income as an addition to the restricted fund balance.

.15 With respect to funds whose use is limited under third-party reimbursement arrangements, Medicare regulations encourage, but do not require, that hospitals fund depreciation by setting aside cash or other liquid assets in a separate fund account to be used for the acquisition or replacement of depreciable assets. Some Blue Cross plans and some state Medicaid programs reimburse hospitals for depreciation only if it is funded. However, most Blue Cross plans and Medicaid programs do not require funding as a prerequisite for depreciation reimbursement. In addition, some state regulations may require assets to be set aside for capital improvements or other purposes. Some health care entities report assets representing funded depreciation or assets set aside for capital improvements or other purposes in the board-designated (noncurrent) section of the general (unrestricted) fund balance sheet. Others report them in the restricted fund section of the balance sheet. The related income from investing those assets is reported either in the statement of revenues and expenses or in the restricted fund balance, respectively.

Views on the Issues

Classifying the Debt

.16 Some believe that when a financing authority issues tax-exempt bonds or similar debt instruments and uses the proceeds for the benefit of a health care entity, the debt should be reported as an obligation

in the general (unrestricted) funds section of the entity's balance sheet. They hold this view because any limitations on the use of the proceeds are imposed by the voluntary action of the governing board. Others believe that the debt should be reported in the restricted funds section of the balance sheet because, generally, the proceeds of the bond issue are administered under the terms of the indenture by an independent trustee. Since the proceeds are limited to use for project costs, they consider them to be restricted and, therefore, the related debt should also be restricted.

Classifying Assets Whose Use Is Limited

.17 Some believe that funds whose use is limited by terms of an indenture agreement or by a third-party reimbursement agreement should be reported in the restricted funds section of the balance sheet, since under the terms of the contract or agreement, such funds cannot be used for other purposes.

.18 Others hold, however, that restricted funds should be used only to account for funds restricted by donors or by grantors (a treatment consistent with the *Hospital Audit Guide*) and that general (unrestricted) funds should be used to account for all other resources. They believe that, although donor restrictions are common in health care entities, debt-financing instruments that contain contract limitations on the use of funds are not unique to health care entities but are prevalent throughout American industry. Such financing agreements or third-party reimbursement agreements are normal and recurring business activities that are necessary for carrying out the organization's objectives and are entered into at the discretion of the governing board and are related to the general (unrestricted) business operations of the entity. Thus, they believe that funds whose use is limited under terms of an indenture agreement or a third-party reimbursement agreement should be reported, with appropriate disclosure, as noncurrent assets in the general (unrestricted) funds section of the balance sheet; they do not support reporting those assets in the restricted funds section of the balance sheet.

.19 Those who net the assets with the corresponding debt during the construction period, either in the restricted or in the general (unrestricted) funds section, maintain that such treatment is preferable since the proceeds of the debt issue are limited to payment for the work in process.

Presenting Investment Income and Expense

.20 Some believe that investment income and interest expense on borrowed funds held by a trustee should be reported separately in the operating section of the statement of revenues and expenses because such amounts are earned or incurred for operating pur-

poses and are necessary to continue normal business operations. Others believe that such amounts should be netted because that treatment recognizes the economics of the transaction, namely, that income generated by the investment of the proceeds reduces the cost of borrowing. Either approach properly matches interest expense and the related investment income on borrowed funds, and each includes the net effect of borrowing in the results of operations.

.21 Others report investment income on borrowed funds held by a trustee and on funded depreciation in the nonoperating section of the statement of revenues and expenses because they believe that this method is consistent with the AICPA *Hospital Audit Guide*, which recommends reporting income from investments of board-designated and other general (unrestricted) funds as nonoperating revenue.

.22 Some report assets as restricted funds and the related investment income as an addition to the restricted fund balance because they consider investment income as an increase in the equity of the restricted funds.

Conclusions

.23 Unrestricted funds should be called general funds (as defined in paragraphs .08, .09, and .10), and the following are the conclusions on the issues addressed in this statement:

- a. Not-for-profit health care entities should report, as liabilities in the general funds section of the balance sheet, obligations issued for their benefit and for repayment of which they are responsible when the obligations are issued.
- b. (1) Only assets restricted by a donor or by a grantor should be reported in the donor-restricted funds section of the balance sheet. Other assets should be reported in the general funds section of the balance sheet.

(2) Assets whose use is limited in substance under terms of debt indentures, trust agreements, third-party reimbursement arrangements, or other similar arrangements should be reported in the general funds section of the balance sheet as assets whose use is limited.
- c. Interest expense and investment income on borrowed funds held by a trustee (to the extent they are not capitalized pursuant to FASB Statement of Financial Accounting Standards No. 62, *Capitalization of Interest Cost in Situations Involving Tax-Exempt Borrowings and Certain Gifts and Grants*) should be reported separately as operating expense or operating revenue, respectively, or alter-

natively, may be netted and reported as operating expense or operating revenue with the offsetting amount disclosed parenthetically. Investment income related to funds whose use is limited under third-party reimbursement arrangements (for example, funded depreciation) and general funds held by a trustee that are not borrowed funds should be reported as nonoperating revenue. If material, each amount should be reported separately.

Effective Date and Transition

.24 This statement of position is effective for fiscal years beginning on or after January 1, 1985, with earlier application encouraged. Accounting changes and reclassifications adopted to conform to the provisions of this statement of position should be applied retroactively by restating the financial statements of prior periods.

.25

APPENDIX

Illustrative Financial Statements

The following illustrate the financial statement presentation of the foregoing discussion. In addition, the accounting policies footnote would describe differences between general funds, including those limited as to use, and restricted funds.

Balance Sheet

Assets whose use is limited under the terms of an indenture agreement, through board designation or through an agreement between the health care entity and an outside party other than a donor or grantor should be reported below current assets in the general fund section of the balance sheet, as follows.

Exhibit 1

(Details of assets reported in the notes to the financial statement)

	<i>General Fund</i>	
	<u>19X1</u>	<u>19X0</u>
ASSETS WHOSE USE IS LIMITED (NOTES X AND Y)		
By board for capital improvements	\$ 300,000	\$ 100,000
By agreements with third-party payors	700,000	400,000
Under bond indenture agreement—held by trustee	3,000,000	2,000,000
Total assets whose use is limited	<u>4,000,000</u>	<u>2,500,000</u>
Less assets whose use is limited and that are required for current liabilities*	(500,000)	(500,000)
Noncurrent assets whose use is limited	<u><u>\$3,500,000</u></u>	<u><u>\$2,000,000</u></u>

*Contra amount reflected as a current asset of the general fund.

Exhibit 2

(Details of assets reported)

	<i>General Fund</i>	
	<u>19X1</u>	<u>19X0</u>
ASSETS WHOSE USE IS LIMITED		
(NOTES X AND Y)		
By board for capital improvements		
Investments	\$ 300,000	\$ 100,000
	<hr/>	<hr/>
By agreements with third-party payors		
Cash	100,000	—
Investments	600,000	400,000
	<hr/>	<hr/>
	\$ 700,000	\$ 400,000
	<hr/>	<hr/>
Under bond indenture agreement—		
held by trustee		
Cash	\$ 500,000	\$ 400,000
Investments	2,500,000	1,600,000
	<hr/>	<hr/>
	\$3,000,000	\$2,000,000
	<hr/>	<hr/>
Total assets whose use is limited	\$4,000,000	\$2,500,000
Less assets whose use is limited		
and that are required for		
current liabilities*	(500,000)	(500,000)
	<hr/>	<hr/>
Noncurrent assets whose use is		
limited	\$3,500,000	\$2,000,000
	<hr/>	<hr/>

*Contra amount reflected as a current asset of the general fund.

Statement of Revenues and Expenses

Income on investments of assets whose use is limited, on board-designated assets, or on those assets whose use is limited in accordance with an agreement between the health care entity and an outside party other than a donor or grantor should be reported in the statement of revenues and expenses as shown in exhibits 3 and 4, based on the following assumptions.

Investment income from board-designated funds	\$ 50,000
Investment income from assets whose use is limited	
Unexpended debt proceeds held by trustee	
under indenture agreement	75,000
Other assets held by trustee	
under indenture agreement ⁽¹⁾	100,000
Depreciation funds	150,000

⁽¹⁾ Includes investment income on funds held by trustee that were not generated through borrowed funds.

Exhibit 3

Investment income on unexpended debt proceeds held by trustee and reported as other operating revenue.

Other operating revenue (Note X)*	\$400,000
Nonoperating revenue	
Unrestricted gifts and bequests	\$400,000
Income on investments	
Board-designated funds	50,000
Assets whose use is limited	
under indenture agreement	100,000
Depreciation funds	150,000
Total nonoperating revenue	\$700,000

*Note X to the financial statements would disclose that other operating revenue includes \$75,000 of interest income on unexpended debt proceeds whose use is limited under an indenture agreement and which are held by a trustee.

Exhibit 4

Investment income on unexpended debt proceeds and interest expense reported as a net amount in operating expense.

Other operating revenue	\$ 325,000
Operating expenses	
Salaries and professional fees	\$ 9,800,000
Supplies and other expenses	7,300,000
Depreciation and amortization	600,000
Interest (Note X)*	400,000
Total operating expenses	<u>\$18,100,000</u>
Nonoperating revenue (same as exhibit 3)	<u>\$ 700,000</u>

*Note X to the financial statements would disclose that interest expense was net of \$75,000 of interest income on unexpended debt proceeds whose use is limited under an indenture agreement and which are held by a trustee.

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➡ The next page is 19,033. ⬅

Section 10,380**Statement of Position 85-2
Accounting for Dollar Repurchase—
Dollar Reverse Repurchase
Agreements by Sellers-
Borrowers**

January 1, 1985

**[Amendment to AICPA Audit and Accounting Guide,
Savings and Loan Associations]****NOTE**

This statement of position significantly amends the AICPA Audit and Accounting Guide, *Savings and Loan Associations*, and provides recommendations on accounting principles for dollar repurchase—dollar reverse repurchase agreements by sellers-borrowers for transactions entered into after December 31, 1984.

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. Statements of position do not establish standards enforceable under rule 203 of the AICPA Code of Professional Ethics. However, Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

Introduction

.01 Mortgage financing that is normally collateralized by residential property is generally originated by financial institutions (mortgagees) directly with the purchasers (mortgagors) of the real estate and is referred to as the primary mortgage market. Direct investment in the primary mortgage market by financial institutions, such as savings and

loan associations (S&Ls), banks, mortgage banks, and credit unions, may not result in efficient channeling of funds to the housing market because of regional disparities in the supply of and demand for mortgage funds. Consequently, a secondary mortgage market was created through government-related agencies to eliminate regional disparities and provide additional mortgage funds in areas where demand exceeds supply.

.02 The Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) have participated in the development and widespread adoption of mortgage-backed securities as a means of financing home loans. Since 1970, the U. S. government has guaranteed, under GNMA sponsorship, timely payments of principal and interest on securities that are issued by private financial institutions and backed by pools of government-insured or government-guaranteed mortgages. GNMA pass-through securities provide for monthly installments of interest on the unpaid balance at the securities' stated certificate rate plus payment of scheduled principal amortization, regardless of the delinquency status of the underlying collateral, together with any prepayment or other recoveries of principal. GNMA pass-through securities are issued by mortgage bankers, S&Ls, and banks that originate FHA-VA mortgages. Instead of selling the mortgages outright or financing them through deposits or other debt, the issuer forms a pool of mortgages, and sells pass-through securities. The issuer collects the mortgage payments and after deducting servicing fees, remits monthly to the certificate holders.

.03 Created by Congress in 1970, the FHLMC has as its primary objective the development of a national secondary market in conventional mortgages. Generally, the FHLMC purchases conventional mortgage loans from financial institutions whose deposits are insured by a U. S. government agency. In 1974, it began to sell mortgage participation certificates, which are similar to GNMA pass-through securities, although they are not backed by the full faith and credit of either the U. S. government or the Federal Home Loan Banks. These certificates represent ownership interest in pools of conventional mortgages purchased by the FHLMC. The FHLMC guarantees the monthly pass-through of interest,

scheduled amortization of principal, and ultimate repayment of principal. Participation certificates are marketed directly by the FHLMC and by a group of securities dealers who also maintain a secondary market in seasoned issues.

.04 GNMA pass-through securities and FHLMC participation certificates are bought and sold in a variety of arrangements, including repurchase—reverse repurchase agreements and dollar repurchase—dollar reverse repurchase agreements.

.05 A repurchase—reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back identical certificates within a specified time at a specified price.¹ These transactions are equivalent to borrowing and lending funds equal to the sales price of the related certificates. For example, if an S&L wants to borrow funds with securities as collateral, it may, instead of borrowing, arrange to temporarily sell its certificates with an agreement to repurchase them on a future date at a specified price. A difference in price represents interest for use of the funds.

.06 Banks and broker-dealers refer to agreements to sell and repurchase as “repurchase agreements.” S&Ls call these same agreements “reverse repurchase agreements.” Similarly, banks and broker-dealers call agreements to purchase and subsequently sell securities “reverse repurchase agreements,” while S&Ls call such transactions “repurchase agreements.” The following illustrates the use of those terms.

- A broker-dealer enters into a contract with another broker-dealer to sell and subsequently repurchase the same security. The broker-dealer that sells and repurchases the security calls it a repurchase agreement. The broker-dealer that buys and sells back the security calls it a reverse repurchase agreement.
- An S&L enters into a contract with another S&L to sell and subsequently repurchase the same security. The S&L that sells and repurchases the security calls it a reverse repurchase agreement. The S&L that buys and sells back the security calls it a repurchase agreement.

¹For purposes of this statement, the term *certificates* refers only to GNMA pass-through certificates and FHLMC participation certificates. Certain financial institutions, such as S&Ls, consider these certificates investments in real estate loans, while others, such as banks and broker-dealers, consider them to be investments or trading securities.

- An S&L enters into a contract with a bank or broker-dealer to sell and subsequently repurchase the same security. The S&L calls it a reverse repurchase agreement and the bank or broker-dealer also calls it a reverse repurchase agreement.

.07 Repurchase—reverse repurchase agreements involve identical securities, and the substance of the transactions is to borrow and lend funds. 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. However, in agreements involving certificates collateralized by dissimilar pools, these transactions would be accounted for as sales and purchases. Due to the increasing complexity and volume of dollar repurchase—dollar reverse repurchase transactions, accounting treatment by the seller-borrower has become increasingly controversial.

.08 A dollar repurchase—dollar reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back certificates of the same agency but not the original certificates. 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 certificates having the same stated interest rate as the interest rate stated on the certificates sold. In a yield maintenance agreement, the parties agree that delivery will be made with certificates that will provide the seller a yield that is specified in the agreement. Distinguishing characteristics of each variation are summarized below.

Fixed Coupon

Certificates sold back or delivered bear the identical contract interest rate and similar maturities as the original certificates.

Certificates collateralized by a similar pool of mortgages, such as single-family residential mortgages, and bearing the same contract interest rate are generally priced to result in substantially the same yield.

Fixed coupon agreements do not contain “par cap” provisions.²

Seller-borrower retains control over the future economic benefits relating to the certificate transferred and assumes no additional market risk.

Yield Maintenance

Certificates sold back or delivered may bear a different contract interest rate from the original certificates.

Certificates collateralized by a similar pool of mortgages but bearing a different contract interest rate are not priced to result in substantially the same yield.

The price spread relationship between certificates with different contract interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the purchaser to deliver, within the terms of the agreement, certificates providing the greatest benefit to the purchaser.

A yield maintenance agreement may contain a “par cap” provision that could significantly alter the economics of the transaction.

Seller-borrower surrenders control over the future economic benefits relating to the certificate transferred and assumes additional market risk.

.09 Believing it desirable to reduce alternative practices in accounting for these agreements, the Accounting Standards Division of the American Institute of Certified Public Accountants has prepared this statement of position to clarify the accounting for the sale of securities or borrowing of funds under dollar agreements.

²A *par cap* is a provision in some yield maintenance agreements limiting the repurchase price to a stipulated percentage of the face amount of the certificate.

Scope

.10 This statement of position applies to accounting for the sale and purchase of securities or borrowing of funds by a fixed coupon or yield maintenance dollar agreement. The recommendations in this statement are limited to transactions involving only GNMA pass-through certificates and FHLMC mortgage participation certificates that the seller-borrower has owned and held in its portfolio for a reasonable period of time, for example, thirty-five days. The recommendations in this statement do not apply to forward placement or delayed delivery contracts for GNMA pass-through certificates or FHLMC mortgage participation certificates or a series of contracts that have the effect of such contracts.³ This statement of position also applies to loans of those certificates if the loans are made under a fixed coupon or yield maintenance dollar agreement. This statement of position does not address accounting and reporting by the purchaser-lender.

.11 This statement of position does not supersede existing accounting principles for other types of repurchase–reverse repurchase transactions as set forth in AICPA audit and accounting guides and statements of position.

.12 This statement of position sets forth the division's conclusions on —

- Accounting for sales and purchases of or borrowing of funds through GNMA pass-through certificates and FHLMC participation certificates under fixed coupon and yield maintenance dollar agreements.
- Accounting for rollovers and extensions of original agreements.
- Accounting for the repurchase of a principal amount different from the principal amount of the original agreement.

³Accounting for forward placement or delayed delivery contracts is not discussed in this statement of position. An AICPA issues paper, "Accounting for Forward Placement and Standby Commitments and Interest Rate Futures Contracts," was sent to the FASB in December 1980.

Present Accounting Practices

Repurchase—Reverse Repurchase Agreements

.13 The 1979 AICPA Audit and Accounting Guide, *Savings and Loan Associations*, addresses repurchases, commonly referred to as *repos*, and concludes that they “represent purchases of securities on a short-term basis under agreements whose terms provide that the sellers will repurchase the securities within a very short period of time, usually a few days.” The S&L guide also concludes that —

In substance, (reverse repurchases or reverse repos) represent borrowings collateralized by the related securities. When funds are borrowed under this (type of) arrangement, a liability should be established for the amount of the proceeds. The investment security account should not be relieved of the collateral securities. Interest on reverse repos should be reported as an expense and not shown net of interest income.

.14 The guidance provided in the S&L guide regarding reverse repurchases is consistent with Statement of Financial Accounting Standards (SFAS) No. 65, *Accounting for Certain Mortgage Banking Activities*, paragraph 8, which states —

Mortgage loans and mortgage-backed securities held for sale that are transferred under formal or informal repurchase agreements of the nature described in this paragraph shall (1) be accounted for as collateralized financing arrangements and (2) continue to be reported by the transferor as being held for sale.

Formal and informal agreements are characterized in SFAS No. 65 as those where the risk of market loss is retained by the mortgage banking enterprise. Further support is provided in the AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, which discusses broker-dealer repurchase transactions. The broker-dealer guide defines a repurchase transaction as “a sale of a security coupled with an agreement by the seller to repurchase the same or substantially identical security at a stated price” and states that “securities owned that are sold by the broker or dealer subject to a repurchase agreement are treated as collateral for financing transactions and not as sales.” Banks use the same terminology and account for the transactions in a manner similar to that used by broker-dealers.

Dollar Repurchase—Dollar Reverse Repurchase Agreements

.15 Dollar agreements differ from repurchase—reverse repurchase agreements because dollar agreements—

- Are represented by different certificates.
- Are collateralized by different, but similar, mortgage pools, for example, single-family residential mortgages.
- Generally have different principal amounts.

.16 Although the AICPA guides and SFAS No. 65 discussed in paragraphs .13 and .14 do not cover dollar agreements specifically, their conclusions appear relevant to dollar repurchase—dollar reverse repurchase agreements. Inherent in the discussions in those guides and SFAS No. 65 is the presumption that the asset (certificate) being “repurchased” is substantially identical in all respects to the asset that was “sold” under the agreement. In a dollar repurchase—dollar reverse repurchase agreement, the certificate that is delivered back may or may not be substantially identical, depending on whether the agreement is a fixed coupon or a yield maintenance dollar agreement.

.17 Paragraph 115 of FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, states that “to have an asset, a business must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to that benefit by others. . . .” In a dollar repurchase—dollar reverse repurchase agreement, the degree of control over the future economic benefits relating to the asset (certificate) transferred by the seller-borrower depends on whether the certificate delivered back is substantially identical. If the delivered certificate is not substantially identical to the transferred original, the seller-borrower has surrendered control over the future economic benefits relating to the original certificate and has obtained the right to acquire a different asset.

Seller-Borrower

.18 The accounting and reporting treatment for the sale of securities or borrowing of funds under dollar agreements varies in practice. Some account for these agreements by relieving the investment securities account of the certificates sold, currently recognizing gains or losses, and recording the purchase of the newly

acquired certificates as a separate transaction. Others account for these agreements as a collateralized financing arrangement. The certificates involved in the transactions are not removed from the investment securities account, gains or losses are not recognized, and a liability is recorded for the amount of the proceeds.

.19 The key factor in distinguishing between the sale and purchase of securities and a financing arrangement is the degree of control over the future economic benefits relating to the certificates transferred by the seller-borrower. If the property repurchased is the identical property sold, the seller-borrower has retained control over the future economic benefits relating to the certificates and has assumed no additional market risk, and the transaction is properly accounted for as a financing arrangement. The seller-borrower in a dollar agreement accepts delivery of certificates that are not identical to the certificates used in originating the transaction. The seller-borrower agrees that the repurchased securities are “substantially identical” to those of the original transaction and therefore are “identical” for purposes of consummating the transaction. Inconsistency in practice in defining “substantially identical” securities and in evaluating risk retention has led to the diversity in accounting for dollar transactions.

.20 Those supporting the view that fixed coupon dollar agreements are financing arrangements believe that certificates in the GNMA market having similar collateral and bearing the same interest rate are priced to result in substantially similar market values. The rationale is that GNMA certificate prices or yields are quoted to investors based on an assumption of a certain payment level of the pooled mortgages, which results in similar market values. GNMA prices or yields are not quoted to investors on the basis of yield to contractual maturity, that is, what the investor’s return would be if none of the pooled mortgages collateralizing the GNMA certificate was prepaid but paid down in accordance with the contractual amortization schedule. For example, prices or yields of single-family mortgage loan pools are quoted on a basis equivalent to that of a single loan that amortizes according to a prescribed thirty-year amortization schedule with prepayment of the balance in the twelfth year. Although this method does not recognize that different pools of mortgages have varied maturities, it has been accepted and provides a uniform method of quoting prices or yields in the GNMA market.

.21 Those supporting the view that fixed coupon dollar agreements are financing arrangements generally agree that fixed coupon agreements containing a “right of substitution” clause do not involve substantially identical securities because of the inherent uncertainty over the type of securities to be repurchased.⁴ Similarly, they also believe that substantially identical securities are not involved if a fixed coupon dollar agreement gives the buyer-lender the option to deliver back to the seller-borrower a certificate having the same coupon rate but priced to result in a significantly different yield, for example, because of differences in payback experience or maturities. In these instances, transactions would be accounted for as the sale and purchase of securities.

.22 Those supporting the view that yield maintenance dollar agreements are sell-buy agreements believe that the purchaser is obligated to deliver or sell back only a certificate with a yield agreed on at the time the transaction originated. Therefore, as noted earlier, the delivered or sold back securities may —

- Bear different certificate interest rates.
- Have different investment principal amounts.
- Possess price spread relationships that do not move in tandem with securities sold.
- Be affected by a “par cap.”

.23 Proponents of sell-buy accounting for yield maintenance agreements also believe the cumulative effect of the differences between the original and repurchased certificates is significant enough to preclude such certificates from being considered substantially identical.

Rollovers and Extensions

.24 Occasionally, certificates involved in dollar agreements are not delivered at the settlement date of the agreement. Instead, the contract is extended or rolled over at the request of the purchaser or seller. If the original contract is accounted for as a financing arrangement, some believe that a rollover or extension agreement is a separate economic transaction and should be accounted for independently of the original contract. Others view the rollover or

⁴A *right-of-substitution clause* is a provision in dollar repurchase-dollar reverse repurchase agreements permitting the buyer to deliver other than substantially identical securities.

extension as merely a continuation of the original contract and do not treat it as a separate economic event for accounting purposes.

Breakage

.25 Certificates repurchased commonly have a principal amount that differs from the principal amount of the certificate originally sold under a dollar agreement. This is referred to as *breakage* and occurs because no two GNMA certificates bear the same principal amount as a result of the monthly amortization of the principal balance of mortgages collateralizing the certificate. It is generally accepted in the marketplace that a “good delivery” (one in accordance with the agreement terms) occurs if the principal amount of the certificates repurchased is within 2.5 percent (plus or minus) of the principal amount of the original certificates. Breakage does not present an accounting practice problem for dollar agreements treated as the sale and purchase of securities. The investment account is reduced by the carrying value of certificates sold and increased by the acquisition cost of the certificates purchased.

.26 Accounting practice for breakage varies for dollar agreement transactions considered to be financing arrangements. If the principal amount of the delivered certificates is greater than that of the original certificates, there is general agreement that the excess cost represents an additional investment and should be accounted for accordingly. However, if the principal amount of the repurchased certificates is less, the accounting treatment varies.

.27 Some make no entry to reflect the reduction in principal amount. This results in a higher cost being assigned to the smaller principal amount of the delivered certificates.

.28 Others reflect the reduction in principal by removing a proportionate share of the original certificates, including the pro rata unamortized original premium (discount), from the accounting records and recognizing any gain or loss. This reduces the investment account to a new cost for the repurchased certificates.

Division's Conclusions

.29 The Accounting Standards Division believes that yield maintenance agreements do not involve substantially similar securities. Fixed coupon agreements do involve substantially identical securities for purposes of this statement.⁵

⁵The AICPA Committee on Banking is studying the issues relating to the definition of “substantially the same,” and is expected to provide guidance. That guidance should be considered when it is available.

Fixed Coupon

.30 Fixed coupon dollar agreements described in this statement of position should be accounted for as collateralized borrowing arrangements (financing) for financial reporting purposes.

.31 Accounting for fixed coupon dollar agreements, except as specified in paragraph .32, should be the same as that used for repurchase—reverse repurchase agreements, as described in paragraph .13. A liability should be recorded for the amount of proceeds, and the certificates should not be removed from the accounting records. The difference between selling price and repurchase price should be accounted for as interest cost that is amortized to expense over the term of the agreement and not shown net of interest income. Amortization of original premium (discount) and interest income on the original certificates should continue to be recorded even if there is an exchange of certificates.

.32 A fixed coupon agreement that contains a right-of-substitution clause or that provides an option to the buyer-lender to deliver back a certificate priced to result in a significantly different yield should be accounted for in the same manner as a yield maintenance agreement.

Yield Maintenance

.33 Yield maintenance dollar agreements should be accounted for as sales with gain or loss recognition⁶ and commitments to purchase securities.

.34 A sold certificate, including unamortized premium (discount), should be removed from the accounts and gains or losses recognized at the time of sale. The commitment to repurchase should be disclosed in the notes to the financial statements. The newly acquired investment should be recorded at cost at the time of purchase.

Rollovers and Extensions

.35 Rollovers and extensions of dollar agreements should be accounted for based on the facts and circumstances at the time of the rollover or extension; for example, the rollover at maturity of a fixed

⁶If the market value of the securities sold differs from the contract price, the gain or loss should be recognized based on the market value.

coupon dollar agreement into another fixed coupon dollar agreement should be accounted for as a financing arrangement. However, when a fixed coupon dollar agreement is rolled over into another fixed coupon dollar agreement with the same coupon rate at a number of successive maturity dates, or when the period of time from initiation to close is lengthy, for example, more than one year, the seller-borrower may not be receiving the risks and opportunities of ownership of a security substantially identical to that of the original security. These transactions should be accounted for as the completion of a financing arrangement resulting in a sale with gain or loss recognition⁷ and a commitment to purchase securities. The rollover at maturity of a fixed coupon dollar agreement into a yield maintenance dollar agreement results in a new contract. The fixed coupon agreement should be accounted for as the completion of a financing arrangement, and the rollover into a new yield maintenance agreement should be accounted for as a sale with gain or loss recognition⁸ and a commitment to purchase securities.

Breakage

.36 If the principal amount of the certificate repurchased in a fixed coupon transaction (financing) is greater than that of those originally sold, the difference should be recorded in the investment account as though a separate acquisition of additional certificates has occurred. If the principal amount is less, the investment account should be relieved of the proportionate share of certificates that have been sold, and gains or losses adjusted for the pro rata share of unamortized premium (discount), should be recognized.

.37 Examples of the accounting for dollar agreements are included in the Appendix of this statement.

Effective Date and Transition

.38 The conclusions of this statement of position should be applied prospectively to transactions entered into after December 31, 1984. Earlier application is encouraged.

⁷See note 6.

⁸See note 6.

.39

APPENDIX

Examples of Accounting for Dollar Agreements**Fixed Coupon*****Accounting by Seller-Borrower*****Facts**

A financial institution owns an 8 percent GNMA pass-through certificate, pool no. 12345, purchased at 100 (face amount) during November 1977. It agrees to sell this certificate (face amount of \$987,436) on January 15, 1980, at its market value (80) and concurrently agrees to repurchase on May 13, 1980, an 8 percent GNMA pass-through certificate (face amount of \$987,436) at a price of $80^{27/32}$. The seller and buyer agree that "good delivery" of the 8 percent GNMA's on the repurchase date will occur if the principal amount is within 2.5 percent (plus or minus) of the \$987,436. For the sake of simplicity, this example assumes no pay-down of principal.

January 15, 1980

Cash	\$ 793,021
Interest income on investment in GNMA ($\$987,436 \times 8\% \times 14/360$)	\$ 3,072
Funds borrowed ($\$987,436 \times 80$)	789,949
To record amounts received under dollar agreement and interest earned from January 1, 1980, to January 15, 1980.	

Summary of Monthly Journal Entries Recorded During the 120-Day Agreement Period

Interest expense on funds borrowed ($\$987,436 \times 8\% \times 120/360$)	\$ 26,332
Interest income on investment in GNMA	\$ 26,332
To record normal interest income/expense on 8% GNMA sold under dollar agreement.	
Interest expense on funds borrowed [$\$987,436 \times (80^{27/32} - 80)$]	\$ 8,331
Accrued interest payable	\$ 8,331
To record differential in price as additional interest expense.	

May 13, 1980

Assumption A

Assume return of an 8 percent GNMA pass-through certificate, pool no. 23451, with a current face amount of \$1,004,878 (within the 2.5 percent range for “good delivery”), which is greater than the original principal amount.

Investment in 8% GNMA, pool no. 23451 (new), $\$987,436 + [(\$1,004,878 - \$987,436) \times 80^{27/32}]$	\$1,001,537
Accrued interest receivable $(\$1,004,878 \times 8\% \times 12/360)$	2,680
Investment in 8% GNMA, pool no. 12345 (old)	\$987,436
Cash (increment in certificate basis) $[(\$14,101) + \text{interest } (\$2,680)]$	16,781
To record additional principal of 8% GNMA, pool no. 23451, and interest earned from May 1, 1980, to May 13, 1980.	

Funds borrowed	\$ 789,949
Accrued interest payable	8,331
Cash	\$798,280
To record repayment of funds borrowed.	

Assumption B

Assume return of an 8 percent GNMA pass-through certificate, pool no. 23452, with a current face amount of \$972,625 (within the 2.5 percent range for “good delivery”), which is less than the original principal amount.

Investment in 8% GNMA, pool no. 23452 (new)	\$972,625
Accrued interest receivable $(\$972,625 \times 8\% \times 12/360)$	2,594
Loss on sale of investment in GNMA, 8% pool no. 12345 $[\$14,811 \times (100 - 80)]$	2,962
Funds borrowed	14,811
Accrued interest payable $[14,811 \times (80^{27/32} - 80)]$	124
Interest income on GNMA investment $(\$14,811 \times 8\% \times 120/360)$	396
Investment in 8% GNMA, pool no. 12345 (old)	\$987,436
Interest expense on funds borrowed (\$124 + \$396)	520
Cash	5,556

To record purchase of 8% GNMA, pool no. 23452, sale of 8% GNMA, pool no. 12345, and reduction of funds borrowed on January 15, 1980.

Note: The reduction in basis (\$987,436 – \$972,625 = \$14,811) between the old certificate and the new certificate is used to determine the amount of loss recognition and to adjust the following accounts: funds borrowed, accrued interest, and interest income as established on January 15, 1980, and during the 120-day period ended May 13, 1980.

Funds borrowed (\$789,949 – \$14,811)	\$775,138	
Accrued interest payable (\$8,331 – \$124)	8,207	
Cash		\$783,345
To record repayment of funds borrowed.		

Summary of Cost of Borrowed Funds

Assumption A

Interest on 8% GNMA, pool no. 12345	\$ 26,332
Difference between sale and repurchase price ($80^{27/32} - 80$)	<u>8,331</u>
Total cost of funds	<u>\$ 34,663</u>
Borrowed funds	<u>\$789,949</u>
$\frac{\text{Cost of Funds } (\$ 34,663)}{\text{Borrowed Funds } (\$789,949)} = .044 \times 3 = 13.2\% \text{ annualized}$	

Assumption B

Interest on 8% GNMA, pool no. 12345	\$ 26,332
Difference between sale and repurchase price ($80^{27/32} - 80$)	8,331
Interest expense adjustment due to reduction in basis	<u>(520)</u>
Total cost of funds	<u>\$ 34,143</u>
Initial borrowed funds	\$789,949
Less partial sale of 8% GNMA, pool no. 12345	<u>14,811</u>
Actual borrowed funds	<u>\$775,138</u>
$\frac{\text{Cost of Funds } (\$ 34,143)}{\text{Borrowed Funds } (\$775,138)} = .044 \times 3 = 13.2\% \text{ annualized}$	

Yield Maintenance

Accounting by Seller-Borrower

Facts

A financial institution owns a 9.5 percent GNMA pass-through certificate, pool no. 34621, purchased at 97 during August 1979. It agrees to sell this

certificate (face amount of \$992,925) on January 15, 1980, at its market value ($86^{22/32}$) and concurrently agrees to repurchase a 9.5 percent GNMA pass-through certificate (face amount of \$992,925) on May 13, 1980, at 88 to yield 11.34 percent. The seller and buyer agree that “good delivery” of the GNMA on the repurchase date will occur if the principal amount is within 2.5 percent (plus or minus) of the \$992,925. They further agree that if the FHA or VA mortgage rate changes during the four-month period, the buyer may deliver on the repurchase date a GNMA pass-through certificate bearing the new current interest rate at a price to produce the above yield of 11.34 percent; however, such price shall not exceed par (yield maintenance agreement with a par cap). For the sake of simplicity, this example assumes no pay-down of principal.

January 15, 1980

Cash	\$864,410	
Loss on sale of investment in 9.5% GNMA, pool no. 34621	102,395	
Unearned discount	29,788	
Investment in 9.5% GNMA, pool no. 34621		\$992,925
Interest income on investment in GNMA ($\$992,925 \times 9.5\% \times 14/360$)		3,668
To record sale of 9.5% GNMA, pool no. 34621, in connection with yield maintenance agreement and interest earned from January 1, 1980, to January 15, 1980.		

Note:

Face amount	\$992,925
Cost (97)	963,137
Unearned discount	\$ 29,788
Market January 15, 1980 ($\$992,925 \times 86^{22/32}$)	<u>\$860,742</u>
Loss ($\$963,137 - \$860,742$)	<u>\$102,395</u>

May 13, 1980

Assumption A

Assume the FHA or VA mortgage rate did not change during the four-month period of the agreement and a 9.5 percent GNMA pass-through certificate, pool no. 18960, with a current face amount of \$989,650 (within the 2.5 percent range for “good delivery”) is delivered to the seller-borrower.

Investment in 9.5% GNMA, pool no. 18960 ($\$989,650 \times 88$)	\$870,892	
Accrued interest receivable ($\$989,650 \times 9.5\% \times 12/360$)	3,133	
Cash		\$874,025

To record purchase of 9.5% GNMA, pool no. 18960, and accrued interest from May 1, 1980, to May 13, 1980.

Assumption B

Assume the FHA or VA mortgage rate did change during the four-month period of the agreement and delivery is made with an 11 percent (current GNMA interest rate) GNMA pass-through certificate, pool no. 48650, with a current face amount of \$998,875 (within the 2.5 percent range for "good delivery") priced at $97^{12/32}$ to provide the agreed yield of 11.34 percent.

Investment in 11% GNMA, pool no. 48650	
$(\$998,875 \times 97^{12/32})$	\$972,655
Accrued interest receivable	
$(\$998,875 \times 11\% \times 12/360)$	3,662
Cash	\$976,317

To record purchase of 11% GNMA, pool no. 48650, and accrued interest from May 1, 1980, to May 13, 1980.

Rollover or Extension

Facts

A financial institution entered a four-month fixed coupon agreement from January 15, 1980, to May 13, 1980. On May 13, 1980, the institution repurchased an 8 percent GNMA pass-through certificate, pool no. 23451, with a face amount of \$1,004,878 and a book basis of \$1,001,537. The institution accounted for the transaction as a financing and recorded journal entries in the manner previously described in this Appendix. Also on May 13, 1980, the institution agrees to sell certificate no. 23451 at its market value (81) and agrees to repurchase an 8 percent GNMA pass-through certificate (current face amount of \$1,004,878) three months later (ninety days) on August 10, 1980.

May 13, 1980

Assumption A — Financing Transaction

Assume a fixed coupon agreement from May 13, 1980, to August 10, 1980.

Cash	\$816,631
Accrued interest receivable	
$(\$1,004,878 \times 8\% \times 12/360)$	\$ 2,680
Funds borrowed $(\$1,004,878 \times 81)$	813,951

To record amounts received under fixed coupon agreement, 8% GNMA, pool no. 23451, from May 13, 1980, to August 10, 1980, and interest received for the period May 1, 1980, to May 13, 1980.

Assumption B — Sell-Buy

Assume a yield maintenance agreement from May 13, 1980, to August 10, 1980.

Cash	\$816,631
Loss on sale of investment in 8% GNMA, pool no. 23451 [$\$1,001,537 - (\$1,004,878 \times 81)$]	187,586
Investment in 8% GNMA, pool no. 23451	\$1,001,537
Accrued interest receivable	2,680

To record sale of 8% GNMA, pool no. 23451, in connection with yield maintenance agreement from May 13, 1980, to August 10, 1980, and interest received for the period May 1, 1980, to May 13, 1980.

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The Savings and Loan Associations Committee gratefully acknowledges the contributions made to the development of this statement of position by Donald A. Zellmer, former chairman of the committee, and Walter E. Erikson, a former member of the committee.

➡➡➡ *The next page is 19,059.* ⬅⬅⬅

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 Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the Institute's Code of Professional Ethics. However, Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations 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, livestock, 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 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 About 7,500 agricultural cooperatives process, market, or purchase agricultural products or perform related services for producers. About 70 to 80 percent of the nation's farmers are patrons of one or more cooperatives.

.007 Of the 7,500 cooperatives, about 1,700 have limited or sporadic operations. According to a 1976 study by the Cooperative Program of the Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture, active cooperatives provide the following services.

Supply	2,164
Marketing	1,674
Combined	<u>1,957</u>
Total	<u><u>5,795</u></u>

.008 In 1976 those cooperatives sold \$51.8 billion of products, had total equity of \$7.7 billion, and had total assets of \$18.6 billion. The 1979 list of *Fortune's* 1,000 largest industrial companies included fifteen cooperatives. Farmland Industries, Inc., the largest, was ninety-first on the list. At least fifty-five cooperatives not on the *Fortune* list had sufficient sales to be included.

.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) 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 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.

.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.

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 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 pro-

duced 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 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 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 4, chapter 6, refers 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, 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, aspara-

gus, 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 arrangements 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 mar-

ket 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 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 percentage 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, 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, 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, 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 non-cash 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 patron-age 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 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. How-

ever, 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.

.107

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	<u>56,500</u>	<u>56,500</u>	<u>—</u>
	84,690	87,926	87,926
Less amounts paid to patrons, retains, and non-patronage earnings	<u>74,430</u>	<u>74,430</u>	<u>74,430</u>
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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➡ *The next page is 19,101.* ←

Section 10,400

Statement of Position 86-1 Reporting Repurchase— Reverse Repurchase Agreements and Mortgage- Backed Certificates by Savings and Loan Associations

September 30, 1986

**[Amendment to AICPA Audit and Accounting Guide,
Savings and Loan Associations.]**

NOTE

This statement of position significantly amends the AICPA Audit and Accounting Guide, *Savings and Loan Associations*, and provides recommendations on reporting repurchase—reverse repurchase agreements and mortgage-backed, pass-through certificates by savings and loan associations in financial statements for the year ending on or after September 30, 1986.

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. Statements of position do not establish standards enforceable under rule 203 of the AICPA Code of Professional Ethics. However, Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

Introduction and Scope

.01 In June 1985 a special task force of the Auditing Standards Board of the AICPA issued a report on auditing repurchase agreements entitled *Report of the Special Task Force on Audits of Repurchase Securities Transactions* (hereafter referred to as "the report"). The nonauthoritative report was the result

of the task force's study of the adequacy of existing guidance on auditing transactions involving repurchase and reverse repurchase (RP—RRP) of securities. In part, the report indicates that there is a presumption that the financial statements of entities engaged in these transactions "reflect both the risks of and the returns from those undertakings."¹ The report also states that "the auditor should evaluate the adequacy of financial statement classification and disclosure of RP—RRP transactions in general and of the status of the collateral in particular."²

.02 The revised edition of the AICPA Audit and Accounting Guide, *Savings and Loan Associations* (hereafter referred to as "the S&L guide"), addresses RP—RRP agreements. For repurchase agreements, the S&L guide states that "if material, these investments should be disclosed separately in the financial statements."³ For reverse repurchase agreements, the S&L guide indicates that a liability should be established for the amount of the proceeds. However, illustrations of disclosures are not provided.

.03 Currently, some savings and loan associations disclose RP—RRP agreements separately. However, in the absence of definitive disclosure requirements, the extent of disclosures relating to RP—RRP agreements has differed. The AICPA Savings and Loan Associations Committee (hereafter referred to as "the committee") believes that specific guidance is needed to achieve uniform reporting practices for transactions involving repurchase and reverse repurchase of securities. Accordingly, this statement of position recommends certain disclosures for RP—RRP agreements, including dollar repurchase—dollar reverse repurchase agreements, by savings and loan associations. In addition, this statement of position modifies the recommended classification of mortgage-backed, pass-through certificates by savings and loan associations as discussed in the S&L guide.

¹ American Institute of Certified Public Accountants, *Report of the Special Task Force on Audits of Repurchase Securities Transactions* (New York: AICPA, 1985), p. 30.

² *Ibid.*, p. 25.

³ American Institute of Certified Public Accountants, *Audit and Accounting Guide, Savings and Loan Associations*, 3d rev. ed. (New York: AICPA, 1986), p. 21. RP—RRP agreements were first addressed in the 1979 revised edition of the S&L guide. The 1986 third revised edition contains the text of the 1979 revised edition plus the above-mentioned *Report of the Special Task Force on Audits of Repurchase Securities Transactions* and Statement of Position 85-2, *Accounting for Dollar Repurchase—Dollar Reverse Repurchase Agreements by Sellers-Borrowers*.

.04 The recommendations in this statement of position are limited to RP—RRP transactions by savings and loan associations involving securities as described in paragraph .06. The statement of position does not address reporting for retail repurchase agreements.⁴

Background

Repurchase and Reverse Repurchase Agreements

.05 The S&L guide addresses RP—RRP transactions and states the following:

An association may invest in short-term repurchase agreements, commonly referred to as “repos.” These transactions represent purchases of securities on a short-term basis under agreements whose terms provide that the sellers will repurchase the securities within a very short period of time, usually a few days . . .

An association may also borrow under repurchase agreements, commonly referred to as “reverse repos.” In substance, these arrangements represent borrowings collateralized by the related securities.⁵

RP—RRP transactions sometimes take the form of dollar repurchase—dollar reverse repurchase agreements. AICPA Statement of Position (SOP) 85-2, *Accounting for Dollar Repurchase—Dollar Reverse Repurchase Agreements by Sellers-Borrowers*, describes the types of RP—RRP transactions and indicates (in paragraph 7) that RP—RRP agreements involve identical securities whereas 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.

.06 The report identifies several uses for RP—RRP agreements—as short-term investments or loans, as a means of

⁴Institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) are permitted to offer to the public *retail repurchase agreements* in amounts of less than \$100,000 and with maturities of less than ninety days. A retail repurchase agreement is an obligation on the part of the issuing institution to pay a sum of money to the purchaser, secured by a perfected security interest in direct obligations of, or obligations fully guaranteed by, the U. S. government or an agency of the U. S. government.

⁵S&L guide, pp. 21-22.

borrowing funds for additional investment, or as a means of financing the purchase of government securities.⁶ Most RP—RRP agreements are contracts for the sale and purchase of U. S. Treasury bonds, bills, and notes. However, the agreements may also be contracts for the sale and purchase of mortgage-backed certificates, bankers' acceptances, negotiable certificates of deposit, and commercial paper. Savings and loan associations' transactions in RP—RRP agreements generally involve U. S. Treasury bonds, bills, and notes, as well as mortgage-backed certificates.

Mortgage-Backed Certificates

.07 SOP 85-2 (paragraphs 1 through 3) describes the establishment of the secondary mortgage market through the development and adoption of mortgage-backed securities. Several organizations, such as the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA), guarantee privately issued securities backed by pools of government-insured or government-guaranteed mortgages.

.08 Under GNMA sponsorship, for example, the U. S. government guarantees timely payments of principal and interest on securities that are issued by private financial institutions and backed by pools of government-insured or government-guaranteed mortgages. GNMA pass-through securities provide for monthly installments of interest on the unpaid balance at the securities' stated certificate rate, plus payment of scheduled principal amortization, regardless of the delinquency status of the underlying collateral, together with any prepayment or other recoveries of principal. GNMA pass-through securities are issued by mortgage bankers, savings and loan associations, and banks that originate Federal Housing Administration—Veterans Administration (FHA—VA) mortgages. Instead of selling the mortgages outright or financing them through deposits or other debt, the issuer forms a pool of mortgages and sells pass-through securities. The issuer collects the mortgage payments and, after deducting servicing fees, remits monthly to the certificate holders.

.09 SOP 85-2, paragraph 4, indicates that mortgage-backed, pass-through securities are bought and sold in several arrange-

⁶ Report, pp. 4-5.

ments, including RP—RRP agreements and dollar repurchase—dollar reverse repurchase agreements.

.10 The S&L guide states the following:

Investments in pass-through certificates have some characteristics common to investment securities; however, they more closely approximate a participating interest in real estate loans. Accordingly, an investing association should account for those investments in a manner consistent with other participating interests in real estate loans.⁷

Current Reporting Guidance

Repurchase and Reverse Repurchase Agreements

.11 Banks, broker-dealers in securities, credit unions, investment companies, and state and local governmental units, as well as savings and loan associations, engage in RP—RRP transactions.⁸ The current reporting practices of some of these entities for RP—RRP transactions are considered in the following discussion.

.12 *Banks.* Banks may invest excess funds by buying U. S. government securities from a borrowing bank or a dealer in U. S. securities. The 1983 AICPA Industry Audit Guide, *Audits of Banks* (hereafter referred to as the “bank audit guide”), states that “federal funds transactions should be stated gross rather than net in the balance sheet, as are securities sold or purchased subject to repo or reverse repo agreements that qualify as short-term loans or borrowings.”⁹ The illustrative financial statements contained in the bank audit guide report the carrying amount of investment securities pledged to secure public deposits and “securities sold under agreements to repurchase” in the investment securities note.

.13 *Broker-dealers.* The 1985 AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, indicates that securities owned by the broker or dealer that are sold subject to a repurchase agreement are reported with trading

⁷ S&L guide, p. 23.

⁸ Banks and broker-dealers refer to agreements to sell and repurchase as “repurchase agreements.” Savings and loan associations call these same agreements “reverse repurchase agreements.” Similarly, banks and broker-dealers call agreements to purchase and subsequently sell securities “reverse repurchase agreements,” whereas savings and loan associations call such transactions “repurchase agreements.”

⁹ American Institute of Certified Public Accountants, *Industry Audit Guide, Audits of Banks* (New York: AICPA, 1983), p. 68.

and investment accounts, at market value, with the amount of the repurchase agreement reflected as a liability. The purchase of securities at a specified price with an agreement to resell the same or substantially identical securities at a definite price at a specified future date is treated as a receivable collateralized by the securities purchased.¹⁰ The illustrative financial statements in the broker-dealer audit and accounting guide report the market value of the securities sold under agreements to repurchase and the average effective interest rate at year-end on the transactions.

.14 Credit unions. The 1986 AICPA Audit and Accounting Guide, *Audits of Credit Unions*, indicates that amounts borrowed under reverse repurchase agreements should be presented separately in the liability section of the statement of financial condition if the amounts are material. Interest rates, due dates, and pledged collateral are among the items that should be disclosed in the notes to the financial statements regarding borrowed funds.¹¹

.15 Savings and loan associations. For repurchase agreements, the S&L guide states the following: "If material, these investments should be disclosed separately in the financial statements."¹² For reverse repurchase agreements, the S&L guide indicates that a liability should be established for the amount of the proceeds. The S&L guide does not provide any recommendations for disclosure of RP—RRP agreements.

.16 Other. An exposure draft of a proposed audit and accounting guide for investment companies discusses RP—RRP agreements and provides recommendations for disclosure of those agreements in the financial statements. Also, in January 1986 the Securities and Exchange Commission (SEC) released rules amending the disclosure requirements of Regulation S-X to require disclosure of the nature and extent of SEC registrants' RP—RRP agreements and the degree of risk involved in those transactions. Finally, in April 1986 the Governmental Accounting Standards Board issued Statement No. 3, *Deposits With Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*.

¹⁰ American Institute of Certified Public Accountants, Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*, rev. ed. (New York: AICPA, 1985), p. 10.

¹¹ American Institute of Certified Public Accountants, Audit and Accounting Guide, *Audits of Credit Unions* (New York: AICPA, 1986), pp. 59-60.

¹² S&L guide, p. 21.

Views on Additional Disclosure by Savings and Loan Associations

Repurchase and Reverse Repurchase Agreements

.17 Currently, other entities that engage in RP—RRP transactions disclose a variety of information about those transactions in the financial statements or in the notes to the financial statements. The committee recognizes that savings and loan associations can look to those reporting practices for guidance. However, the committee believes it should provide specific guidance for savings and loan associations to achieve uniform reporting practices and enhance comparability.

.18 The report identified several risks related to RP—RRP agreements:

- Business risk
- Market risk
- Credit risk
- Risk of collateral loss ¹³

.19 The report describes business risk as the risk that a party entering into RP—RRP agreements will misunderstand the terms of the agreements. Consequently, the party may misunderstand the economics of the transactions and incorrectly assess the risks it is in fact assuming, the return it hopes to earn, or the financing costs it is incurring.

.20 Price changes or market risk may affect the ability of one party to an agreement to continue to finance it and the ability of the other party to repurchase the securities at the maturity of the agreement. Changes in prices also affect the margin in a transaction (the “haircut”); this may create a need for the seller-borrower to transfer additional securities or return cash.

.21 The report states that credit risk is the risk that a borrower may not be able to repay a loan. RP—RRP agreements can be viewed as a loan of cash by one party and a loan of securities by another. At maturity, both “loans” are “repaid.” There is a risk that the buyer-lender, having sold or otherwise transferred the securities to third parties, will not have sufficient resources at the maturity of the agreement to obtain the securities required for resale to the seller-borrower. There is also a

¹³ Report, pp. 17-20.

risk that the seller-borrower will not have sufficient funds to repay the loan (repurchase the securities). Thus, credit risk is faced by both parties to the transaction.

.22 Finally, when a seller-borrower transfers securities to a securities dealer under a reverse repurchase agreement, there is a risk of collateral loss; that is, the dealer may not be able to sell the securities back at the agreed-upon price. The report indicates that if the seller-borrower has the legal right to set off the securities against the borrowed funds, the potential economic loss is limited; the loss is then the excess of the market value of the securities (plus accrued interest) at the date of the sale over the amount borrowed, plus or minus any change in that market value and accrued interest.¹⁴ In that case, the risk of losing the collateral is essentially the same as market and credit risk.

.23 If a buyer-lender, under a repurchase agreement with a securities dealer, does not perfect a security interest in securities purchased (for example, by having a signed agreement and by taking possession either directly or through a custodian acting as its agent), the potential economic loss is the amount advanced plus accrued interest, and the risk assumed becomes that of an unsecured lender, namely, credit risk. Collateral risk for the buyer-lender is reduced if definitive collateral is held by the dealer's custodian as the dealer's agent with specific identification of the assignee or if book entry collateral is transferred directly or by a notation entry. Collateral risk is reduced further if the buyer-lender or its agent, which could be the dealer's bank acting as the lender's agent, takes possession of the collateral.

.24 The legal considerations involved in RP—RRP agreements are important when evaluating the risk of collateral loss. The report states the following:

A buyer-lender in an RP—RRP transaction does not automatically obtain a perfected security interest in the underlying securities. . . . To create a valid security interest under the Uniform Commercial Code, the safest approach is to have a separate signed agreement specifically creating the security interest and to perfect the security interest, nor-

¹⁴ The accounting loss may be greater or less than the economic loss if the book value of the securities is above or below their market value.

mally by possession of the collateral.* Some RP—RRP participants provide explicitly in their agreements for security interests that would have standing as such under the Uniform Commercial Code. More commonly, however, RP—RRP transactions do not create security interests; instead, they involve only a pair of matched confirmations that are similar to an initial purchase or sale transaction coupled with a forward contract that will reverse the first transaction at a price that provides for the payment to the buyer-lender of what is, in effect, interest.

...

Possession of the underlying securities may be obtained either directly by the buyer-lender or indirectly through a third party that, acting as the buyer-lender's agent, takes possession of and holds the securities for the exclusive use of the buyer-lender. Such a custody agreement should be evidenced in writing for the buyer-lender's protection, and the custodian should be required to specifically identify and segregate the securities held for the buyer-lender.

...

Government securities dealers, but not certain financial institutions such as commercial banks and savings and loan associations, are subject to the Bankruptcy Code. The FHLBB [Federal Home Loan Bank Board] in October 1984 indicated that its policy, in cases in which the Federal Savings and Loan Insurance Corporation (FSLIC) was the receiver of an insured institution, was not to limit the contractual rights of the buyer-lender to sell securities underlying repurchase agreements except in cases of fraud or other extraordinary circumstances. Similar action has not been taken, however, by the FDIC [Federal Deposit Insurance Corporation], but its practices have been consistent with those formally adopted

* The Uniform Commercial Code has been enacted, with some variations, in all states except Louisiana. Article 8 of the model code, which deals with investment securities, was revised in 1977 to cover, among other things, book entry securities, but only some states adopted the revisions. In those that did, a security interest may be created and perfected in several ways, none of which requires the filing of a formal notice. Even if a security interest has not been created and perfected, the courts may choose, for one reason or another, to recognize a particular RP—RRP agreement as a secured loan. Currently, ongoing litigation concerning Bevill, Bresler & Schulman Asset Management Corp., E.S.M. Government Securities, Inc., and other dealers may yield judicial precedents on what is required to perfect a security interest under the Uniform Commercial Code. Moreover, questions have been raised as to whether implications could be drawn from relevant U. S. Treasury regulations that would cast doubt on the applicability of the 1977 revisions to the Uniform Commercial Code as they apply to U. S. government securities. As suggested in a later section of this report, auditors should consider whether an opinion from the client's legal counsel should be obtained regarding the status of the securities underlying an RP—RRP transaction.

by the FHLBB. The powers of receivers and conservators of bankrupt institutions that are not subject to the Bankruptcy Code are governed by many differing federal and state statutes and regulations. Accordingly, the rights of each party to the underlying securities in case of insolvency may not always be treated by the courts in the manner specified in the particular RP—RRP agreement (or master agreement). Nevertheless, those agreements should contain language that defines what each party intends its rights to be.¹⁵

.25 The report states that there is “a presumption that the financial statements reflect both the risks of and the returns from those undertakings. . . .”¹⁶ Further, the report states that “conceptually, the nature of, and the risks involved in, an RP—RRP agreement may affect the classification and valuation of accounts reported on the face of the financial statements or the disclosures reported in the notes thereto. . . . Because of such matters as the right to return similar but not the same collateral and the variation in the length of the agreement (possibly to the maturity of the security), difficult judgments must be made by financial statement preparers regarding their substance.”¹⁷ The report recommends that “the appropriate accounting standard-setting bodies should consider requiring disclosure information to assist users in assessing the risks assumed in RP—RRP agreements and of the amounts by which both the carrying value and the market value of the underlying securities in those agreements exceed the cash proceeds.”¹⁸ The committee concurs with this recommendation, believing that a combination of disclosures will provide readers of an association’s financial statements with the information necessary to assess the association’s position with respect to the various risks.

.26 For example, disclosure of the market value of the securities underlying the agreements, coupled with the description of the association’s method for handling the collateral, provides the reader with information to assess the potential economic and accounting loss in the event that the transactions are not completed according to their terms. Volume and rate data on reverse repurchase agreements provide information on the association’s method and cost of funding. Volume data also

¹⁵ Report, pp. 12-14. For further discussion on the legal considerations of RP—RRP agreements and the underlying securities, see these pages of the report.

¹⁶ *Ibid.*, p. 30.

¹⁷ *Ibid.*, pp. 30-31.

¹⁸ *Ibid.*, p. 31.

supply information on the amount of exposure under reverse repurchase agreements during the period as well as at the end of the period.

.27 The report also states that the “auditor’s proper role is to evaluate whether . . . disclosures reflect the substance of RP—RRP transactions and are in other respects in conformity with generally accepted accounting principles.”¹⁹ The committee believes additional guidance on reporting RP—RRP transactions for savings and loan associations will assist the auditor in that role.

Mortgage-Backed Certificates

.28 Many RP—RRP agreements by savings and loan associations involve mortgage-backed, pass-through securities. The S&L guide states that “such securities provide a means for associations to invest available funds in easily transferable packages of real estate loans or to sell such packages to generate needed cash.”²⁰ Thus, mortgage-backed certificates provide savings and loan associations with a more liquid, marketable investment than the underlying mortgage loans. Mortgage-backed certificates traditionally have been included in loans receivable in the financial statements. However, some savings and loan associations classify mortgage-backed certificates separately from loans receivable in recognition of the above characteristics.

.29 Statement of Financial Accounting Standards (SFAS) No. 65, *Accounting for Certain Mortgage Banking Activities*, establishes accounting and reporting standards for certain mortgage banking activities. Mortgage-backed, pass-through certificates held for sale by mortgage bankers, as well as by banks and by savings and loan associations that conduct operations substantially similar to the primary operations of mortgage bankers, are reported at the lower of cost or market value, determined as of the balance sheet date. Paragraph 9 of SFAS No. 65 provides guidance for determining the market value of mortgage-backed certificates. Paragraph 28 of SFAS No. 65 states that mortgage banking enterprises shall distinguish between “(a) mortgage loans and mortgage-backed securities held for sale and (b) mortgage loans and mortgage-backed securities held for long-term investment.”

¹⁹ Ibid.

²⁰ S&L guide, p. 22.

.30 The S&L guide recognizes that investments in pass-through certificates have some characteristics common to investment securities. The S&L guide also indicates that the market value of investment securities should be disclosed parenthetically in the financial statements or the notes.²¹ The bank audit guide discusses the importance of market value information.

Disclosure of the market value of investment securities, in either the balance sheet or the notes to the financial statements, helps a reader of a bank's financial statements to evaluate the potential earning power of those investments, since the potential earning power is governed by prevailing market interest rates applied to the estimated market value and not the book value of the bank's invested assets. Disclosure of the market value is required.²²

Some savings and loan associations currently report the market value of mortgage-backed certificates. The committee believes the market value of mortgage-backed certificates provides important information to the users of an association's financial statements.

Recommendations

.31 The AICPA Savings and Loan Associations Committee recommends the following.

Repurchase and Reverse Repurchase Agreements

The following should be disclosed in the financial statements or in the notes to the financial statements.

a. Disclosures for the end of the period:

1. Securities purchased under agreements to resell (repurchase agreements), including—
 - A description of the securities underlying the agreements
 - The cost of the agreements, including accrued interest
 - The market value of the securities underlying any agreement if less than the cost of that agreement
 - The maturity of the agreements

²¹ Ibid., p. 20.

²² Bank audit guide, p. 34.

- The dollar amount of agreements to resell the same securities
 - The dollar amount of agreements to resell substantially identical securities
 - Any material concentrations at the end of the period.²³
If any material concentrations exist at the end of the period, disclosure should be made of the association's control of the securities underlying the agreements.²⁴
If concentrations at the end of the period vary from those during the period, consideration should be given to disclosing this information.
2. Securities sold under agreements to repurchase (reverse repurchase agreements), including—
- A description of the securities underlying the agreements
 - The book value, including accrued interest of the securities underlying the agreements
 - The market value of the securities underlying the agreements
 - The maturity of the agreements
 - The weighted-average interest rate of the agreements
 - The dollar amount of agreements to repurchase the same securities

²³ "Material concentration" refers to the dollar amount of assets at risk under agreements outstanding at the report date with any one dealer. "Assets at risk" is defined as the amount of funds advanced plus accrued interest if the securities underlying the agreements are not in the possession of the association or its agent. If the securities underlying the agreements are in the possession of the association or its agent, assets at risk is defined as the amount of funds advanced plus accrued interest less the market value of the securities underlying the agreements if less than cost. Materiality should be considered in relation to the association's net worth as well as to its operations.

²⁴ "Control" refers to the ability of the association to exercise legal authority over the securities that serve as the collateral for the RP—RRP agreement in the event of default by the counterparty. The association has a different loss exposure if it lacks control over the collateral in a repurchase transaction than if it lacks control over the collateral in a reverse repurchase transaction.

Control of the assets underlying a repurchase transaction exists if (1) the association holds the securities that serve as collateral for the agreement and (2) the association, upon default by the counterparty, has the ability to obtain the collateral benefit from those securities. Control may also exist if the association, instead of holding the securities, has the collateral held in the name of or for the benefit of the association by an independent third party, and condition (2) above is met. Lack of control exposes the association to risk of loss of the amount invested.

In a reverse repurchase agreement, the counterparty, for its benefit, usually exercises control over the securities underlying the agreement. The association has a risk exposure to the extent that its assets that serve as the collateral exceed the amount borrowed, including accrued interest.

- The dollar amount of agreements to repurchase substantially identical securities
 - Any material concentrations at the end of the period.²⁵
If any material concentrations exist at the end of the period, disclosure should be made of the association's control of the securities underlying the agreements.²⁶
If concentrations at the end of the period vary from those during the period, consideration should be given to disclosing this information.
- b. Disclosures for RP—RRP agreements during the period:
1. The maximum amount of outstanding agreements at any month-end during the period
 2. The average amount of outstanding agreements for the period
 3. A statement of whether the securities underlying the agreements were under the association's control

Mortgage-Backed, Pass-Through Certificates

Investments in mortgage-backed, pass-through certificates should be reported separately in the statement of financial condition. The market value of the mortgage-backed, pass-through certificates should be disclosed in the statement of financial condition or in the notes to the financial statements.

.32 The appendix to this statement of position provides illustrations of these disclosures.

Effective Date and Transition

.33 The recommendations in this statement of position should be applied to financial statements for the year ending on or after September 30, 1986. Earlier application is encouraged.

²⁵ "Material concentration" refers to the dollar amount of assets at risk under agreements outstanding at the report date with any one dealer. "Assets at risk" is defined as the book value of securities sold under agreements to repurchase, including accrued interest plus any cash or other assets on deposit to secure the repurchase obligation, less the amount borrowed against it (adjusted for accrued interest). Materiality should be considered in relation to the association's net worth as well as to its operations.

²⁶ See note 24.

.34

APPENDIX

Illustrative Financial Statement Disclosures

This appendix contains illustrations of the disclosures in the financial statements of savings and loan associations recommended in the statement of position. The appendix amends the illustrative financial statements contained in the revised edition of the Audit and Accounting Guide, *Savings and Loan Associations*. The following disclosures are illustrative and other formats are acceptable.

Stock Savings and Loan Association
Statements of Financial Condition*

<u>Assets</u>	<u>September 30</u>	
	<u>19X7</u>	<u>19X6</u>
Cash (including certificates of deposit of \$1,300,000 (19X7) and \$2,400,000 (19X6))	\$ 1,563,478	\$ 2,751,112
Securities purchased under agreements to resell (Note X)	XXXX	XXXX
Investment securities (Notes 5 and Y)		
U. S. government (including agencies)		
Market value \$2,346,000 (19X7) and \$2,141,000 (19X6)	2,400,100	2,200,038
Municipals		
Market value \$1,970,000 (19X7) and \$2,474,000 (19X6)	2,125,008	2,565,093
Other		
Securities carried at market in 19X7 and at cost in 19X6 (cost in 19X7 of \$411,150; market in 19X6 of \$283,000)	365,000	275,055
Mortgage-backed certificates, market value XXXX (XXXX at 19X6) (Note Y)	XXXX	XXXX
Loans receivable, net (Notes 2 and 4)	136,134,319	119,997,601
Real estate		
Acquired in settlement of loans less allowance for losses of \$85,566 (19X7) and \$70,141 (19X6)	1,101,238	1,423,676
Acquired for development (Note 5)	1,119,578	1,176,295
Office properties and equipment, at cost, less accumulated depreciation of \$1,127,888 (19X7) and \$1,006,424 (19X6)	5,034,036	4,793,748
Federal Savings and Loan Insurance Corporation secondary reserve prepayment	997,723	972,155
Federal Home Loan Bank stock, at cost (Note 4)	2,073,400	1,291,700
Accrued interest receivable	843,874	736,453
Other assets	635,840	283,100
	<u>\$154,393,594</u>	<u>\$138,466,026</u>

The accompanying notes are an integral part of the financial statements.

*These sample financial statements from pages 98 to 109 of the revised edition of the Audit and Accounting Guide, *Savings and Loan Associations*, have not been revised for other disclosures currently required under generally accepted accounting principles. They are presented here only to illustrate the disclosures recommended in the statement of position. The committee is currently revising the S&L guide, and the sample financial statements contained in the updated guide should be reviewed when it is available.

**Reporting Repurchase—Reverse Repurchase Agreements and
Mortgage-Backed Certificates by Savings and Loan Associations**

19,117

<u>Liabilities and stockholders' equity</u>	<u>September 30</u>	
	<u>19X7</u>	<u>19X6</u>
Savings accounts (Note 3)	\$119,162,437	\$114,532,863
Advances from Federal Home Loan Bank (Note 4)	24,880,000	13,500,000
Securities sold under agreements to repurchase (Note Y)	XXXX	XXXX
Other borrowed money (Note 5)	1,361,615	2,800,000
Advances from borrowers for taxes and insurance	701,141	677,576
Federal income taxes (Note 7)		
Current	36,300	29,000
Deferred	234,700	187,000
Other liabilities	2,295,585	1,144,700
Total liabilities	<u>148,671,778</u>	<u>132,871,139</u>
Stockholders' equity		
Capital stock—\$1 par value, 500,000 shares authorized; 297,340 shares issued and outstanding	297,340	297,340
Additional paid-in capital	148,670	148,670
Retained earnings—substantially restricted (Note 6)	5,321,956	5,148,877
Net unrealized loss on marketable equity securities (Note 1)	(46,150)	—
Total stockholders' equity	<u>5,721,816</u>	<u>5,594,887</u>
Commitments (Note 9)		
	<u>\$154,393,594</u>	<u>\$138,466,026</u>

Notes to Financial Statements

Note X. Securities Purchased Under Agreements to Resell

	<i>September 30</i>	
	<u>19X7</u>	<u>19X6</u>
Securities purchased under agreements to resell, including accrued interest		
Mortgage-backed certificates with a market value of XXXX (XXXX at 19X6)	XXXX	XXXX
U. S. government securities with a market value of XXXX (XXXX at 19X6)	XXXX	XXXX
	<u>XXXX</u>	<u>XXXX</u>

The association enters into purchases of securities under agreements to resell (repurchase agreements). The amounts advanced under these agreements represent short-term loans and are reflected as a receivable in the statement of financial condition. The securities underlying the agreements are book entry securities. During the period, the securities were delivered by appropriate entry into the association's account maintained at the Federal Reserve Bank of New York (or MBS Clearing Corporation for GNMA securities) or into a third-party custodian's account designated by the association under a written custodial agreement that explicitly recognizes the association's interest in the securities. At September 30, 19X7, these agreements matured within ninety days. The agreements relating to mortgage-backed certificates were agreements to resell substantially identical securities. At September 30, 19X7, no material amount of agreements to resell securities purchased was outstanding with any individual dealer. Securities purchased under agreements to resell averaged XXXX and XXXX during 19X7 and 19X6, and the maximum amounts outstanding at any month-end during 19X7 and 19X6 were XXXX and XXXX, respectively.

Note Y. Securities Sold Under Agreements to Repurchase

	<i>September 30</i>	
	<i>19X7</i>	<i>19X6</i>
Securities sold under agreements to repurchase		
Mortgage-backed certificates with a book value including accrued interest of XXXX (XXXX at 19X6) and a market value of XXXX (XXXX at 19X6)	XXXX	XXXX
U. S. government securities with a book value including accrued interest of XXXX (XXXX at 19X6) and a market value of XXXX (XXXX at 19X6)	XXXX	XXXX
	<u>XXXX</u>	<u>XXXX</u>
	<u>XXXX</u>	<u>XXXX</u>

The association enters into sales of securities under agreements to repurchase (reverse repurchase agreements). Fixed-coupon reverse repurchase agreements are treated as financings, and the obligations to repurchase securities sold are reflected as a liability in the statement of financial condition. The dollar amount of securities underlying the agreements remains in the asset accounts. The securities underlying the agreements are book entry securities. During the period, the securities were delivered by appropriate entry into the counterparties' accounts maintained at the Federal Reserve Bank of New York (or MBS Clearing Corporation for GNMA securities). At September 30, 19X7, these agreements had a weighted-average interest rate of 8.92 percent (9.23 percent at September 30, 19X6) and matured within one year.* At September 30, 19X7, XXXX of the agreements relating to mortgage-backed certificates were agreements to repurchase substantially identical securities. At September 30, 19X7, XXXX of the agreements involving mortgage-backed certificates with a book value of XXXX and a market value of XXXX were transacted with one primary dealer. The mortgage-backed certificates underlying the agreements were delivered to the dealers who arranged the transactions. The dealers may have sold, loaned, or otherwise disposed of such securities to other parties in the normal course of their operations, and have agreed to resell to the association substantially identical securities at the maturities of the agreements. Securities sold under agreements to repurchase averaged XXXX and XXXX during 19X7 and 19X6, and the maximum amounts outstanding at any month-end during 19X7 and 19X6 were XXXX and XXXX, respectively.†

* A tabular presentation of maturities would also be acceptable.

† The association should consider disclosing the average interest rate of the agreements during the period.

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 ➡ The next page is 19,131. ←

Section 10,410***Statement of Position 87-1
Accounting for Asserted and
Unasserted Medical Malpractice
Claims of Health Care Providers
and Related Issues*****March 16, 1987****NOTE**

This statement of position applies to all health care providers and provides guidance concerning medical malpractice insurance financial-reporting issues.

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 areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the AICPA Code of Professional Ethics. However, Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles that the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

Introduction

.01 Health care providers have traditionally purchased occurrence-basis insurance to protect themselves against losses from malpractice claims. Such losses include the costs of claims investigation and settlement resulting from allegedly improper professional health care services provided to patients. The cost of such insurance is fixed at the beginning of the policy term, and the premium has been charged to expense pro rata over the term of the policy.

.02 The changing social and economic environment has both increased the cost and limited the availability of occurrence-basis medical malpractice insurance. Insurance companies have substantially raised premiums or restricted the degree of risk they were willing to assume. As a result, some health care providers have dropped their insurance coverage; others have kept their coverage but modified it to retain more of their malpractice risk by accepting higher deductibles, by purchasing retrospectively rated policies, by forming captive insurance companies, or by joining with others to form multiprovider captive insurance companies. Still other providers have purchased claims-made policies, which cover only claims reported to the insurance carrier during the policy term. Today, few health care providers have full insurance protection against losses from medical malpractice claims, and careful evaluation of ongoing insurance protection is required whenever one of the above modifications is made.

.03 Many health care providers established trust funds as a means of funding the cost of uninsured (also referred to as self-insured) malpractice claims and related expenses. Others simply pay such costs out of general funds when they are incurred.

.04 Accounting for asserted and unasserted medical malpractice claims has become diverse. The diversity is compounded by the use of captive insurance companies, retrospectively rated policies, claims-made insurance programs, and trust funds because accounting pronouncements offer no specific guidance in those areas. Neither the AICPA's 1972 *Hospital Audit Guide* nor the AICPA's 1978 Statement of Position (SOP), *Clarification of Accounting, Auditing and Reporting Practices Relating to Hospital Malpractice Loss Contingencies*, provides specific guidance on those accounting issues. Accordingly, this statement has been prepared (a) as a basis for reducing the existing diversity of practice and (b) as a guide on accounting for uninsured asserted and unasserted medical malpractice claims and related issues.

Definitions

.05 The following are definitions of terms used in this statement.

Asserted claim. A claim made against a health care provider by or on behalf of a patient alleging improper professional service.

Claims-made policy. A policy that covers only malpractice claims covered by the policy reported to the insurance carrier during the policy term.

Discounting. Measuring the cost of malpractice claims at the present value of the estimated future payments.

Health care provider. A person or other entity or group of entities under common control that delivers health care services, including, but not limited to, hospitals, nursing homes, and practices of physicians, dentists, or other health care specialists.

Multiprovider captive. An insurance company owned by two or more health care providers that underwrites malpractice insurance for its owners.

Occurrence-basis policy. A policy that covers claims resulting from incidents that occur during the policy terms, regardless of when the claims are reported to the insurance carrier.

Reported incident. An occurrence identified by a health care provider, usually under some form of claim-management-reporting system, as one in which improper professional service may be alleged, thereby resulting in a malpractice claim.

Retrospectively rated policy. An insurance policy with a premium that is adjustable based on the experience of the insured health care provider or group of health care providers during the policy term.

Self-insurance. Risk of loss assumed by a health care provider. No external insurance coverage.

Tail coverage. Insurance designed to cover malpractice claims incurred before, but reported after, cancellation or expiration of a claims-made policy.

Trust fund. A fund established by a health care provider to pay malpractice claims and related expenses as they arise. (In the case of a government, the trust fund often is established as an "internal service fund.")

Ultimate cost. Total claim payments, including costs associated with litigating or settling claims.

Unasserted claim. A medical malpractice claim that has not been, but may in the future be, asserted by or on behalf of a patient related to a reported or unreported incident.

Unreported incident. An occurrence in which improper professional service may have been administered by the health care provider that may result in a malpractice claim. The occurrence, however, has not yet been identified by the health care provider under a formal or informal claims-reporting system.

Wholly owned captive. An insurance company subsidiary of a health care provider that provides malpractice insurance primarily to its parent.

Scope

.06 This statement applies to all health care providers and their wholly owned and multiprovider-owned captive insurance companies.

Relevant Accounting Pronouncements

.07 Three accounting pronouncements provide guidance on accounting for medical malpractice claims: FASB Statement No. 5, *Accounting for Contingencies*, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and the 1978 AICPA Statement of Position, *Clarification of Accounting, Auditing, and Reporting Practices Relating to Malpractice Loss Contingencies*. The following discussion cites relevant passages from those pronouncements.

Accounting for Uninsured Asserted and Unasserted Malpractice Claims

.08 An issue in accounting for uninsured asserted and unasserted malpractice claims is whether a health care provider should accrue for the ultimate cost of uninsured asserted and unasserted malpractice claims when incidents occur. Other accounting issues include how such losses should be accrued and how those accrued losses should be classified in the financial statements.

Discussion

.09 Many health care providers that do not obtain insurance for their malpractice risks establish risk management systems

to reduce their exposure to malpractice claims. Risk management systems are designed (a) to reduce the likelihood of incidents that may result in malpractice claims, (b) to identify such incidents that have occurred and to correct the underlying causes, (c) to minimize the amount of payments made on reported claims, and (d) to provide for the availability of financial resources to settle claims.

.10 For accounting purposes, the two major categories of malpractice loss contingencies are asserted and unasserted claims. *Asserted claims* are claims made against a health care provider by or on behalf of a patient alleging improper professional service. *Unasserted claims* (that is, incurred but not reported claims) are claims that have not been asserted by or on behalf of a patient and may relate to either—

- a. *Reported incidents*, which are occurrences that have been identified by the health care provider, usually under some form of claims management reporting system, as incidents in which improper care may be alleged, thereby resulting in malpractice claims, or—
- b. *Unreported incidents*, which are occurrences that have not yet been identified by the health care provider under a formal or informal claims-reporting system as incidents in which improper professional service may be alleged, and can result in malpractice claims.

.11 The 1978 SOP provides limited guidance on accounting for uninsured malpractice claims. That SOP requires estimated losses resulting from malpractice claims to be accounted for in accordance with FASB Statement No. 5 and FASB Interpretation No. 14. Accordingly, an expense should be accrued if an incident has occurred that will probably result in an uninsured loss and if the amount can be reasonably estimated. In making the estimate, prior claim experience should be considered, including an analysis of the frequency of past claims. The SOP indicates that a qualified actuary may be helpful in deriving an estimate of claims incurred but not reported and also in quantifying the uncertainties inherent in such estimates.

.12 FASB Interpretation No. 14 states that if it is probable a loss has been incurred but that only a range of loss can be reasonably estimated, the loss should still be accrued. However, in such circumstances, the most likely amount in the range

should be accrued. If no amount is more likely than any other amount, the minimum amount should be accrued, and the amount of any potential additional loss should be disclosed in the notes to the financial statements.

Present Practices

.13 Some health care providers accrue estimated losses from malpractice claims based on information developed from their risk management systems. Losses from asserted claims are based on the best estimate of the cost of settling or litigating the claims, including the expense of settlement and litigation (ultimate cost). Many of those estimates are made by claims managers or attorneys.

.14 Losses from unasserted claims arising from reported incidents are estimated and accrued either individually or in groups. Individual accrual is based on an analysis of each incident; group accrual is based on the historical relationship between unasserted claims arising from reported incidents and eventual loss.

.15 Some health care providers also estimate and accrue losses from unreported incidents. Those estimates are generally based on the provider's experience of the relationship between unreported incidents and eventual losses or on industry experience. Losses from reported and unreported incidents are often estimated with the help of actuaries.

.16 Other health care providers accrue amounts for estimated losses from malpractice claims based on actuarially determined payments to a trust fund or captive insurance company. Many of those payments represent the present value of expected future payments for malpractice claims less amounts previously funded and amounts to be funded in future years. Those amounts generally result in leveling the reported expense of malpractice claims over a period of years and are not usually based on incidents occurring in the current year.

Views on the Issues

.17 Some believe that the ultimate costs of malpractice claims should be accrued when the incidents that cause them occurred, if it can be determined that it is probable that losses have been incurred and if the amounts can be reasonably esti-

mated. However, they maintain that the ability to make reasonable estimates varies for asserted and unasserted claims. They believe that accrual of estimated losses from asserted claims and the related settlement and litigation expenses should be based on the best estimate of the costs of settling or litigating the claims.

.18 These individuals also believe that estimated losses from reported incidents should be accrued if sufficient information is available from the health care provider's own experience to determine—either individually or on a group basis—that it is probable that losses have been incurred and that they can be reasonably estimated. In addition, they maintain that estimated losses from unreported incidents should also be accrued if the health care provider has sufficient statistics on its paid claims that resulted from unreported incidents to provide a basis on which to estimate the amount of such losses. However, if a health care provider does *not* have sufficient historical experience on which to estimate losses from reported or unreported incidents, they believe the cost of such claims should not be accrued. The existing contingency should be disclosed in the notes to the financial statements.

.19 Others maintain that the actuarially determined payment to a trust fund or captive insurance company should be accrued as an expense in the health care provider's financial statements because the amount was determined by an actuary, who is a specialist in the field. They believe that Statement on Auditing Standards No. 11, *Using the Work of a Specialist*, supports their position. SAS No. 11 states in paragraph 9 that "if the auditor determines that the specialist's findings support the related representations in the financial statements, he may reasonably conclude that he has obtained sufficient evidential matter." Those who support accruing actuarially determined payments contend that accountants do not have the level of expertise to challenge an actuary's recommendations.

.20 Others believe that actuarially determined payments frequently include amounts that do not meet the criteria for accrual under FASB Statement No. 5 for the following reasons:

- a. Actuarially determined payments generally result in leveling the cost of malpractice claims over a period of years. For example, if it is probable that a \$1 million loss will occur

some time in the next five years, \$200,000 may be funded in each of the next five years. For accounting purposes, \$1 million should be accrued in the year the incident occurred if the amount of loss can be reasonably estimated at that time.

- b. Many actuarially determined payments are computed at the request of the health care provider at the beginning of a year or earlier, and, therefore, the health care provider's claim experience for that year is not considered.
- c. The actuarial computations may be based on industry experience rather than on the health care provider's claim experience. If the health care provider's claim experience differs materially from the experience of others, the actuarial determinations would not conform with FASB Statement No. 5.
- d. Actuarially determined payments may contain provisions for adverse deviation that do not conform with FASB Statement No. 5, which requires an accounting accrual based on reasonable estimates of incurred losses.

Conclusions

.21 The ultimate costs of malpractice claims, which include costs associated with litigating or settling claims, should be accrued when the incidents occur that give rise to the claims, if it can be determined that it is probable that liabilities have been incurred and if the amounts of the losses can be reasonably estimated.

.22 *Estimating the Amount of Loss.* If it is probable that a loss has been incurred and the information available indicates the loss is within a range of amounts, the most likely amount of loss in the range should be accrued. If no amount in the range is more likely than any other, the minimum amount in the range should be accrued, and the potential additional loss should be disclosed if there is at least a reasonable possibility of loss in excess of the amount accrued. (See FASB Interpretation No. 14.) If the range of loss cannot be reasonably estimated, no loss should be accrued.

.23 Estimated losses should be reviewed and changed if necessary at each reporting date; the amounts of the changes would be recognized currently as additional expense or reductions of expense.

.24 *Asserted Claims and Unasserted Claims Arising From Reported Incidents.* Estimated losses from asserted claims should be accrued either individually or on a group basis, based on the best estimates of the ultimate costs of the claims. Estimated losses from unasserted claims arising from reported incidents should be accrued individually or on a group basis, using the relationship of past reported incidents to eventual claim payments. All relevant information, including industry experience, should be used in estimating the expected amount of asserted claims and unasserted claims arising from reported incidents.

.25 *Unreported Incidents.* A health care provider should accrue estimated losses from unreported incidents based on its best estimate of the ultimate costs. Those estimates should be based on all available evidence that is relevant to estimating unreported incidents that have occurred as well as the *amount of loss* related to those estimated incidents. Such evidence may include industry experience, the provider's own historical experience, and the provider's existing asserted claims and reported incidents. The accrual should be limited to an estimate of the losses that will result from unreported incidents that are probable of having occurred before the end of the reporting period.

.26 In estimating the extent to which unreported incidents are probable of having occurred, some health care providers may develop a range of possible estimates of the number of unreported incidents, including zero. However, the greater the volume of a health care provider's operations, the greater the likelihood that the provider's minimum estimate of the number of probable unreported incidents will be greater than zero.

.27 *Use of Industry Experience.* In estimating losses from malpractice claims, a health care provider should use data on industry experience only to the extent that such data is relevant to developing an estimate specific to the entity. The relevance of industry data depends principally on the comparability of the health care provider with the entities whose experiences are used in developing that data. Various factors, such as the nature of operations, size, and geographic location, should be considered in assessing comparability. Further, industry data that is not current may not be relevant. How the health care provider plans

to use the data affects which factors are more important in a given circumstance, as indicated in the following examples:

- a. In estimating the amount of loss, the nature of the incident would typically be critical in using industry data.
- b. In estimating the extent to which unreported incidents have occurred, the comparability of a provider's business activity and risk management system to that of the other providers included in the industry data would be critical in determining whether and how industry experience can be used. (Not being able to make such comparisons of the risk management systems would indicate that industry data should not be used in estimating the extent of a provider's probable unreported incidents.)

.28 Accrued unpaid claims and expenses that are expected to be paid during the normal operating cycle (generally within one year of the date of the financial statements) should be classified as current liabilities; all other accrued unpaid claims and expenses should be classified as noncurrent liabilities.

.29 *Disclosure.* A health care provider should disclose its program of medical malpractice insurance coverages and the basis for any related loss accruals. If the health care provider cannot estimate losses relating to a particular category of malpractice claims (for example, asserted claims, reported incidents, or unreported incidents) in accordance with paragraphs .22 through .27, the potential losses related to that category of claims should not be accrued. However, the contingency should be disclosed in the notes to the financial statements, as required by FASB Statement No. 5.

Disclosure of Discounting Accrued Unpaid Malpractice Claims

.30 An issue in accounting for medical malpractice claims is what should be disclosed by health care providers that discount accrued unpaid medical malpractice claims.

Discussion

.31 The relevant accounting pronouncements are not specific about whether unpaid malpractice claims should be recorded at the estimated ultimate cost of settlement or at the present value

of anticipated future cash payments. Because of the substantial delay between the date an incident occurs and the date the claim is paid, the difference between recording the amount of accrued asserted and unasserted claims at their estimated ultimate cost of settlement and at their present value is significant.

Conclusions

.32 A task force of the Accounting Standards Division is considering the accounting implications of certain discounting applications, including discounting insurance claims. Until the discounting issue is resolved, health care providers that discount accrued malpractice claims should disclose in the notes to their financial statements the carrying amount of accrued malpractice claims that are discounted in the financial statements and the interest rate(s) used to discount those claims (see FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, paragraph 60(d)).

Accounting for Claims-Made Policies and Tail Coverage

.33 An issue in accounting for a claims-made policy is whether a health care provider should accrue for the ultimate costs of malpractice claims and incidents not reported to the insurance carrier during the term of the policy. Other issues include (a) how that accrual should be made and (b) whether buying tail coverage satisfies the requirement to provide for the costs of malpractice claims and incidents not reported to the insurance carrier.

Discussion

.34 Many health care providers now buy claims-made malpractice insurance. A claims-made policy differs from an occurrence-basis policy in that it covers only claims reported to the insurance carrier during the policy term. If a claims-made policy is not continually renewed or if tail coverage is not obtained when the policy is discontinued, a health care provider is uninsured for malpractice claims reported to the insurance carrier after the termination of the policy, regardless of when the incidents occurred.

.35 An accounting issue to be addressed is whether a health care provider with a claims-made policy should accrue a liability

for estimated losses relating to unasserted claims and incidents not reported to the insurance carrier, although they may be covered by future claims-made policies.

.36 A health care provider may terminate a claims-made policy and buy tail coverage. If so, another accounting issue to be addressed is whether the cost of tail coverage should be charged to expense when the decision is made to terminate the claims-made policy or whether the cost should be deferred and amortized to expense over the period that claims are expected to be reported.

Present Practices

.37 Few health care providers now accrue for estimated losses from unasserted claims and incidents not reported to the insurance carrier that are expected to be covered under future claims-made policies.

.38 Most health care providers charge the cost of tail coverage to expense in the periods in which they obtain the coverage.

Views on the Issues

.39 Some believe that a claims-made policy represents a transfer of risk within the policy limits to the insurance carrier and that it is unnecessary to accrue for estimated losses from unasserted claims and unreported incidents to be covered under future claims-made policies. They maintain that such accrual would be necessary only if the health care provider decided not to renew a claims-made policy or the insurance carrier indicated it would not renew the policy and tail coverage was not going to be or could not be obtained.

.40 Others believe that a claims-made policy does not transfer risk to the insurance carrier for unasserted claims and incidents not reported to the insurance carrier; they maintain that the health care provider should accrue for such claims. The accrual should be reversed when the claims are subsequently reported and covered by a claims-made or tail coverage policy.

.41 Some believe the premium for tail coverage should be charged to expense when the coverage is obtained because the premium relates to past occurrences.

.42 Others believe recognition in expense of the cost of tail coverage should be deferred. They maintain that it should be

charged to expense over the estimated period in which the claims will be reported because the tail coverage is a continuation of the claims-made policy.

Conclusions

.43 A claims-made policy represents a transfer of risk within the policy limits to the insurance carrier for asserted claims and incidents reported to the insurance carrier; however, this policy does not represent a transfer of risk for claims and incidents not reported to the insurance carrier. Consequently, a health care provider that is insured under a claims-made policy should account for the estimated cost of those claims and incidents not reported to the insurance carrier in accordance with paragraphs .22 through .27. This should be done unless the health care provider has bought tail coverage and included the cost of the premium as expense in the financial statements for that period.

Accounting for Retrospectively Rated Premiums

.44 The issues to be addressed in accounting for retrospectively rated premium policies are (a) how health care providers should account for premiums and (b) what disclosures of estimated losses should be made under such policies if the ultimate premiums are based primarily on each health care provider's loss experience or on the experience of a group of health care providers.

Discussion

.45 The premium for a nonretrospectively rated policy is fixed for the period of the contract and is usually charged to expense pro rata over the contract period. However, for a retrospectively rated policy, an estimated or deposit premium is generally paid to the insurance company at the inception of the contract period. The deposit premium usually consists of a minimum premium, representing the insurance company's expenses and profits, plus an amount for estimated claims experience. During the term of the policy, the deposit premium is adjusted, subject to any minimum and maximum premium limitations of the contract, based on the experience of the health care provider.

.46 Some retrospectively rated policies are primarily based on the experience of the individual health care provider and some

are primarily based on the experience of a group of health care providers. Other policies may be based on some combination of both individual and group experience.

Present Practices

.47 Some health care providers account for minimum premiums paid to insurance companies on retrospectively rated policies as expense over the period of coverage and recognize estimated losses in excess of the minimum premium from asserted and unasserted claims as additional insurance expense for the period.

.48 Others amortize premiums on retrospectively rated policies over the period of coverage and recognize adjustments resulting from favorable or unfavorable claim experience in the financial statements when the insurance company reports them.

Views on the Issues

.49 A retrospectively rated policy may provide that the insurer will not return the minimum premium regardless of the degree of favorable experience and, if experience is unfavorable, that the insured will only be required to pay a maximum amount. Some believe an estimate of the total premium ultimately to be paid should be charged to expense over the term of the contract.

.50 Those who support that view maintain that health care providers retain risk of loss up to the maximum premium under those contracts. Estimated losses from asserted and unasserted claims should be accrued as indicated in paragraphs .22 through .27 up to that maximum amount.

.51 Others believe that minimum premiums on retrospectively rated policies should be amortized pro rata over the period of coverage. Retrospective premium adjustments should be recorded as adjustments of insurance expense when the insured is notified of such adjustments. Those who support this view maintain that the premium is the best estimate of losses from asserted and unasserted claims and, therefore, should be the insurance expense for the period.

Conclusions

.52 A health care provider with a retrospectively rated medical malpractice insurance policy whose ultimate premium is based

primarily on the health care provider's loss experience should account for the minimum premium as expense over the period of coverage under the policy and accrue estimated losses from asserted and unasserted claims in excess of the minimum premium as indicated in paragraphs .22 through .27. However, such estimated losses should not be accrued in excess of a stipulated maximum premium. If the health care provider cannot estimate losses from asserted or unasserted malpractice claims as indicated in paragraphs .22 through .27, the health care provider should disclose the existing contingency in the notes to the financial statements (see paragraph .29).

.53 A health care provider insured under a retrospectively rated policy with premiums based primarily on the experience of a group of health care providers should amortize the initial premium to expense pro rata over the policy term. The provider should also accrue additional premiums or refunds on the basis of the group's experience to date, which should include provision for the ultimate cost of asserted and unasserted claims before the financial statement date, whether reported or unreported. The health care provider should disclose (a) that it is insured under a retrospectively rated policy and (b) that premiums are accrued based on the ultimate cost of the experience to date of a group of providers. If the health care provider cannot estimate losses from asserted or unasserted malpractice claims as indicated in paragraphs .22 through .27, it should disclose the existing contingency in the notes to the financial statements (see paragraph .29).

Accounting for Medical Malpractice Claims Insured With Captive Insurance Companies

.54 In accounting for medical malpractice claims insured with wholly owned and multiprovider owned captive insurance companies, an accounting issue to be considered is how health care providers should account for estimated losses from asserted and unasserted claims.

Discussion

.55 Some health care providers have formed wholly owned subsidiaries to insure the parent entity and possibly other health

care providers. Those entities are captive insurance companies for which FASB Statement No. 60 specifies the accounting.

.56 Other health care providers have formed multiprovider captive insurance companies to insure their medical malpractice claims. Those entities are also captive insurance companies for which FASB Statement No. 60 specifies the accounting. A multiprovider captive insurance company is commonly formed by a group of health care providers that are related geographically, that are affiliated or under common control, such as by members of a religious community, or that have similar malpractice claims experience. A multiprovider captive insurance company may be formed to (a) spread the risk of malpractice claims among a number of similar institutions, (b) obtain excess coverage at a lower cost, or (c) provide for advance funding of the cost of malpractice claims within the provisions of reimbursement regulations. The captive may retain the entire risk assumed from its insureds or it may obtain excess coverage from a commercial insurance company.

.57 Premiums on some policies issued by multiprovider captives are fixed for the period of the contract. However, premiums on many policies issued by such insurers are retrospectively rated. Such premiums may be based on the experience of the individual health care provider or on the experience of the group. The arrangements between providers and their captive may be complex; a careful analysis is generally required to determine the extent of coverage that in fact is provided by the captive. If, for instance, the insurance contract requires a premium essentially equal to claims incurred by the provider plus a fee for expenses and profit, the captive is, in effect, only a claims-paying agent.

Present Practices

.58 Financial statements of health care providers generally do not disclose the method of accounting for captive insurance companies.

Views on the Issues

.59 Some believe that a health care provider that is insured by its wholly owned captive is, in substance, uninsured. They believe, therefore, that the same considerations apply in accounting for estimated losses from uninsured asserted and unasserted

malpractice claims of the parent as described in paragraphs .21 through .29. FASB Statement No. 5, paragraph .27, states that "uninsured risks may arise in a number of ways, including . . . insurance through a subsidiary or investee to the extent not reinsured with an independent insurer." A footnote to that paragraph states that "the effects of transactions between a parent or investor and a subsidiary or investee insurance company shall be eliminated from an enterprise's financial statements."

.60 Similarly, some believe that policies issued by multi-provider captives in which the premiums are based on the experience of the individual health care providers are, in substance, not insurance. Thus, the premiums should be accounted for as expense over the periods of coverage; estimated losses from asserted and unasserted claims should be accrued and reported as indicated in paragraphs .21 through .29. However, if the premiums are based on the experience of the group, they should be amortized to expense pro rata over the terms of the policies.

.61 Others believe that for retrospectively rated policies issued by multiprovider captives, with the premiums based only on the health care provider's individual experience, the initial premiums should be amortized to expense pro rata over the terms of the policies. Premium adjustments should be recorded only when the health care providers are notified by the multiprovider captives.

Conclusions

.62 The financial statements of a health care provider insuring medical malpractice claims through a wholly owned captive insurance subsidiary must include provisions for estimated losses from asserted and unasserted claims as indicated in paragraphs .21 through .29. That may be done directly in the financial statements of the health care provider or in consolidation of the financial statements of the wholly owned captive.

.63 A health care provider insured by a multiprovider captive insurance company for medical malpractice claims under a retrospectively rated insurance policy whose ultimate premium is primarily based on the health care provider's experience up to a maximum premium, if any, should account for such insurance as indicated in paragraph .52.

.64 A health care provider insured by a multiprovider captive insurance company for medical malpractice claims under a retrospectively rated policy based primarily on the experience of a group of health care providers should account for such insurance as indicated in paragraph .53. However, the health care provider should consider whether the economic substance of the multiprovider captive is sufficient to relieve the health care provider from further liability. The health care provider should disclose (a) that it is insured under a retrospectively rated policy of a multiprovider captive and (b) that premiums are accrued based on the captive's experience to date.

.65 A health care provider that is insured by a multiprovider captive should disclose in its financial statements that it is insured by a multiprovider captive, and it should disclose its ownership percentage in the captive as well as the method of accounting for its investment in and the operations of the captive. In addition, if the health care provider cannot make the necessary estimates of losses from asserted or unasserted claims as indicated in paragraphs .22 through .27, the health care provider should disclose the existing contingency in the notes to the financial statements (see paragraph .29).

Accounting for Trust Funds

.66 Another issue is how a health care provider should account for a trust fund established to make resources available to settle malpractice claims.

Discussion

.67 One of the objectives of a risk management system is to make sure that sufficient resources are available to settle malpractice claims as they come due. Some health care providers establish trust funds in an attempt to make sure that financial resources are available to pay claims. In most circumstances, a trustee controls the trust fund assets and the trust agreement provides that the assets can be used only to investigate, litigate, and settle malpractice claims and to pay administrative expenses of the trust fund.

.68 Diverse practices have developed for reporting medical malpractice trust funds and their revenues and administrative expenses in the financial statements of the health care provider.

Present Practices

.69 Some health care providers treat a payment to a trust fund as a transfer of funds from one case account to another. Others exclude the trust fund from their financial statements and charge the payment to an expense account. They recognize a liability for unpaid claims only to the extent that claims exceed the amount in the trust fund. Revenues, generally interest income, and administrative expenses of the trust fund are recorded in the financial statements of the health care provider only if the trust fund is included in the statements.

Views on the Issues

.70 Some believe that a trust fund, whether legally revocable or irrevocable, should be included in the health care provider's financial statements because establishing a trust fund does not relieve the health care provider of the financial responsibility for malpractice claims. A health care provider cannot limit its legal obligations for malpractice claims to the amount in the trust fund; a malpractice claimant can look to all the assets of the health care provider as well as to the trust fund to satisfy a malpractice claim. A medical malpractice trust fund cannot be compared to a pension fund because, under certain circumstances, a company's pension obligations can be limited to the amount in the pension fund.

.71 Others maintain that a medical malpractice trust fund is comparable to a pension fund and should not be reported in the health care provider's financial statements. They believe that because future malpractice claims will be paid from the trust fund, establishing a fund provides a transfer of risk and that only malpractice claims exceeding the amount in the trust fund should be reported in the health care provider's financial statements. They also maintain that there is no significant distinction for accounting purposes between assets held in revocable and irrevocable trusts because the assets of the trust are used solely to discharge obligations for unpaid claims.

.72 Some believe that a trust fund included in the financial statements of the health care provider should be classified as a current asset, and others maintain that it should be classified as a noncurrent asset. Still others believe that classification should

depend on the classification of estimated unpaid malpractice claims.

Conclusions

.73 A trust fund, whether legally revocable or irrevocable, should be included in the financial statements of the health care provider. A portion of the fund equal to the amount of assets expected to be liquidated to pay malpractice claims classified as current liabilities should be classified as a current asset; the balance of the fund, if any, should be classified as a noncurrent asset. In the financial statements of the health care provider, revenues of the trust fund should be included with other operating revenues; the administrative expenses of the trust fund should be included with other administrative expenses. In some circumstances the foregoing may not be possible: for example, if a common trust fund exists for a group of health care providers; if the health care provider is part of a common municipality trust fund; and if legal, regulatory, or indenture restrictions prevent the inclusion of a trust fund in a health care provider's financial statements. In those circumstances, the provisions of paragraphs .74 and .75 still apply.

.74 Estimated losses from asserted and unasserted claims should be accrued and reported as indicated in paragraphs .21 through .29 and should not be based on payments to the trust fund.

.75 A health care provider's financial statements should disclose the existence of the trust fund, and, if the trust is irrevocable, that should also be disclosed.

Effective Date and Transition

.76 This statement is effective for fiscal years beginning after June 30, 1987, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this statement should be applied retroactively. In the year this statement is first applied, the financial statements should disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related amounts per share for each year restated.

.77 If retroactive restatement of all years presented is not practicable, the financial statements presented should be restated

for as many consecutive years as practicable. The cumulative effect of applying the statement should be included in determining net income of the earliest year restated, which is not necessarily the earliest year presented. If it is not practicable to restate any prior year, the cumulative effect should be included in net income in the year in which the statement is first applied, in conformity with paragraph 20 of APB Opinion 20, *Accounting Changes*. For that year, what should be disclosed is the following: the effect on income before extraordinary items, net income, and related per share amounts of applying this statement in a year in which the cumulative effect is included in determining that year's net income.

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ACC TOPICAL INDEX

STATEMENTS OF POSITION

References are to section numbers.

ACCESSIONS

- Definition 10,250.126
- Nonprofit Organizations 10,250.114

ACCOUNTABILITY

- Contractors 10,330.26
- Nonprofit Organizations 10,250.056—058;
10,250.091, 10,250.113, 10,250.123

ACCOUNTING CHANGES

- Bank's Investment Securities Gains or Losses 10,360.16
- Completed-Contract Method 10,330.90—91
- Disclosure Requirements 10,330.90—91;
10,360.16
- Estimate Changes 10,330.19; 10,330.25;
10,330.82—84
- Government Contracts 10,330.19
- Hospital-Related Organizations 10,340.13
- Marketable Equity Securities 10,160.17
- Materiality 10,330.84
- Municipal Bond Funds 10,260.40
- Percentage of Completion Method 10,330.25; 10,330.82—84, 10,330.90—91

ACCOUNTING INTERPRETATIONS

- (AICPA)
- APB Opinion No. 18 10,240.06; 10,240.11

ACCOUNTING POLICIES

- Colleges and Universities 10,020.11
- Completed-Contract Method 10,330.31—32; 10,330.52
- Construction-Type Contracts 10,330.02;
10,330.21
- Disclosure Requirements 10,330.21;
10,330.25; 10,330.31
- Equalization Accounting 10,260.33—34
- Hospitals 10,160.01—17
- Investment Companies 10,140.45
- Medical Malpractice Claims 10,410.01—77
- Municipal Bond Funds 10,260.31
- Percentage of Completion Method 10,330.22—25; 10,330.32—33
- Production-Type Contracts 10,330.02;
10,330.21
- Real Estate Ventures 10,240.02, 10,240.26;
10,240.34

ACCOUNTING PRINCIPLES BOARD

- Opinion No. 11 10,130.15
- Opinion No. 16 10,240.27
- Opinion No. 18 10,240.01, 10,240.04—07,
10,240.10—12, 10,240.21, 10,240.28
- Opinion No. 19 10,240.13
- Opinion No. 20 10,160.17; 10,260.40;
10,330.83—84, 10,330.90—91
- Opinion No. 22 10,330.21
- Opinion No. 25 10,130.07
- Statement No. 4 10,060.27, 10,330.03

ACCOUNTING RECORDS

- Nonprofit Organizations 10,250.011

ACCOUNTING RESEARCH BULLETINS

- No. 43, Chap. 11 10,330.07
- No. 43, Introduction 10,160.01
- No. 45 10,330.04—05, 10,330.28—29, 10,330.44

ACCOUNTING RESEARCH BULLETINS—

- continued
- No. 51 10,340.08

ACCOUNTING SERIES RELEASES

- Release No. 113 10,260.16—17
- Release No. 118 10,260.16—17

ACCOUNTING STANDARDS DIVISION (AICPA)

- Colleges and Universities 10,020.05
- Investment Companies 10,140.01—02
- Personal Financial Statements 10,350.04,
10,350.12; 10,350.33
- Program Accounting 10,330.14; 10,330.75
- Real Estate Investment Trusts 10,060.29C;
10,170.02; 10,170.06

ACCOUNTING TERMINOLOGY BULLETINS

- No. 1, Review and Resumé 10,250.106

ACCURAL BASIS ACCOUNTING

- Colleges and Universities 10,020.10—11
- Nonprofit Organizations 10,250.011—013
- Personal Financial Statements 10,350.07

ACTUARIES

- Medical Malpractice Claims 10,410.11;
10,410.16; 10,410.19—20

ADVANCES

- Agricultural Cooperatives 10,390.002;
10,390.082
- Receivable—See Loans Receivable

AFFILIATES

- Nonprofit Organizations 10,250.008,
10,250.046—047, 10,250.090

AGENCIES

- Contractors 10,330.58—60
- Municipal Bond Funds 10,260.14

AGENCY FUNDS

- Educational Funds 10,020.11—12
- Nonprofit Organizations 10,250.090;
10,250.123

AGRICULTURAL COOPERATIVES

- Accounting by 10,390.001
- Advances 10,390.082
- Agricultural Marketing Act of 1929 10,390.009
- Assigned Amounts 10,390.002
- Bargaining Cooperatives 10,390.020
- Cash Advance Method 10,390.002;
10,390.072; 10,390.078, 10,390.086
- Characteristics of a Cooperative 10,390.010—012
- Definition 10,390.006—022
- Exempt and Nonexempt 10,390.002;
10,390.017
- Federated Cooperatives 10,390.022
- Financial Statements 10,390.105, 10,390.107
- Income Taxes 10,390.014, 10,390.017
- Inventories 10,390.067—086
- Investments In 10,390.087—105
- Local Cooperatives 10,390.022

AGRICULTURAL COOPERATIVES—

- continued
- Marketing Cooperatives 10,390.002,
10,390.019—.021; 10,390.063—.086
- Member and Nonmember 10,390.002
- Patron 10,390.002; 10,390.063—.086
- Patronage 10,390.002
- Patronage Allocations 10,390.002,
10,390.068; 10,390.090—.093; 10,390.097—.105
- Patronage Earnings 10,390.002; 10,390.014—.018
- Patrons' Product Deliveries 10,390.063—.086, 10,390.107
- Pooling Basis 10,390.064—.086
- Pools 10,390.002
- Price Adjustment Theory 10,390.015—.016
- Retains 10,390.002
- Service Cooperatives 10,390.020
- Supply Cooperatives 10,390.002;
10,390.019—.020
- Written Notice of Allocation 10,390.002

AGRICULTURAL PRODUCERS

- Accounting by 10,390.001—.005
- Accounting for Growing Crops 10,390.026
- Accounting for Inventories of
Crops 10,390.023—.039
- Activities 10,390.004—.005
- Cost as Inventory Basis 10,390.036
- Definition 10,390.003—.005
- Development Costs—See
Development Costs
- Farm Price Method 10,390.002; 10,390.026
- Livestock 10,390.002
- Market as Inventory Basis 10,390.027—.037

AICPA—See American Institute of CPAs**ALLOCATION OF COSTS**

- Construction-Type Contracts 10,330.02;
10,330.06; 10,330.69—.72; 10,330.87
- Depreciation 10,250.106—.107
- Future Benefits 10,330.70
- Government Contracts 10,330.08
- Municipal Bond Funds 10,260.39
- Nonprofit Organizations 10,250.091,
10,250.096—.100; 10,250.127
- Production-Type Contracts 10,330.69—.72;
10,330.87

**ALLOWANCES FOR LOAN LOSSES—See
Loan Loss Allowances****ALLOWANCES, VALUATION**

- Marketable Equity Securities 10,160.04;
10,160.07; 10,160.15—.17
- Real Estate 10,240.30

**ALTERNATIVE ACCOUNTING
PRINCIPLES**

- Commitment Fees 10,060.42
- Contracts 10,330.05—.06; 10,330.21
- Employee Stock Ownership Plans 10,130.03
- Hospital-Related Organizations 10,340.05—.06
- Loan Loss Allowances 10,060.09; 10,060.14
- Nonprofit Organizations 10,250.006—.007,
10,250.026; 10,250.055—.063; 10,250.077—.078
- Percentage of Completion Method 10,330.80—.81
- Real Estate Industry 10,240.02

AMERICAN COUNCIL ON EDUCATION

- Publisher of *College and University
Business Administration* 10,020.02

AMERICAN INSTITUTE OF CPAs

- Auditing Standards Division—See
Auditing Standards Division (AICPA)
- Banking Committee 10,360.03—.06;
10,360.16—.18

AMERICAN INSTITUTE OF CPAs—

- continued
- Committee on Accounting
Procedure 10,330.04—.05
- Subcommittee on Health Care
Matters 10,160.02; 10,340.06—.07

AMORTIZATION

- Collections 10,250.115
- Commitment Fees 10,060.42—.46
- Deferred Costs of Investment
Companies 10,140.02; 10,140.44—.45
- Discount on Bonds 10,260.30—.31
- Intangible Assets 10,240.27
- Marketable Debt Securities 10,250.079—.080
- Premiums on Bonds 10,260.30—.32;
10,260.39

ANNUITY AND LIFE INCOME FUNDS

- Educational Institution 10,020.11—.12

ANNUITY GIFTS

- Definition 10,250.126
- Nonprofit Organizations 10,250.121
- Personal Financial Statements 10,350.26

APB—See Accounting Principles Board**APPRAISAL VALUE**

- Fixed Assets 10,250.105
- Municipal Bonds 10,260.13
- Personal Financial Statements—See
Personal Financial Statements

APPROPRIATIONS

- Colleges and Universities 10,020.10—.12
- Undrawn 10,020.10

ASSETS

- Affected by Debt Restructuring 10,060.13;
10,060.29A—.29C; 10,170.03—.06
- Capital 10,020.10
- Change in Classification 10,160.06
- Colleges and Universities 10,020.10
- Current—See Current Assets
- Definition 10,020.10
- Employee Stock Ownership Plans 10,130.06
- Estimated Current Value 10,350.02—.04;
10,350.06; 10,350.10—.26; 10,350.31
- Fixed—See Fixed Assets
- Hospital-Related Organizations 10,340.10
- Hospitals 10,340.04—.05; 10,340.10
- Impairment of Value—See Impairment
of Value
- Leases—See Leases
- Municipal Bond Funds 10,260.35; 10,260.37
- Nonexhaustible 10,250.108; 10,250.113
- Nonprofit Organizations 10,250.019—.024;
10,250.029; 10,250.046
- Personal Financial Statements—See
Personal Financial Statements
- Pledges Receivable 10,250.064—.066
- Precontract Costs 10,330.73—.75
- Real Estate Ventures 10,240.09; 10,240.14;
10,240.20; 10,240.25—.28
- Useful Life—See Useful Life
- "When Issued" Securities 10,260.20

AUDIT GUIDES (AICPA)

- Banks 10,360.02—.04; 10,400.12; 10,400.30
- Broker/Dealers in Securities 10,380.14;
10,400.13
- Colleges and Universities 10,020.01—.12;
10,250.001; 10,250.057; 10,250.077
- Construction Contractors 10,330.18
- Credit Unions 10,400.14
- Government Contractors 10,330.04;
10,330.18—.19; 10,330.72; 10,330.93

AUDIT GUIDES (AICPA)—continued

- Hospitals 10,160.02; 10,160.16; 10,250.001;
10,250.057, 10,340.05—.08, 10,370.05—.06,
10,370.10—.11; 10,370.18, 10,370.21
- Investment Companies 10,030.01—.06;
10,140.01—.46; 10,260.01—.40; 10,350.19
- Personal Financial Statements 10,350.02
- Savings and Loan Associations 10,380.13—
14; 10,400.01—.34
- State and Local Governmental
Units 10,250.001
- Voluntary Health and Welfare
Organizations 10,250.001; 10,250.055

**AUDITING STANDARDS DIVISION
(AICPA)**

- Bank's Investment Securities Gains or
Losses 10,360.16

AUDITOR, INDEPENDENT

- Repurchase—Reverse Repurchase
Agreements 10,400.27
- Valuation of Municipal Bonds 10,260.10—
28

**BALANCE SHEETS—See Statements of
Financial Position**

BANKS

- Investments in Securities 10,360.01—.18
- Loans to ESOPs 10,130.02—.03
- Mortgage—See Mortgage Banks
- Mutual Savings—See Mutual Savings
Banks
- Repurchase—Reverse Repurchase
Agreements 10,380.06; 10,380.14; 10,400.12

BENEFITS

- Allocation of Costs 10,330.70
- Contributors to Nonprofit
Organizations 10,250.049
- Fund-Raising Activities 10,250.092—.093
- Nonprofit Organizations 10,250.007,
10,250.044; 10,250.067
- Precontract Costs 10,330.73—.75

BEQUESTS

- Nonprofit Organizations 10,250.028—.029;
10,250.051, 10,250.054—.063, 10,250.095

BILLINGS ON CONTRACTS

- Back Charges 10,330.76—.77
- Completed-Contract Method 10,330.30
- Construction-Type Contracts 10,330.06
- Costs of Billing 10,330.69
- Percentage of Completion Method
10,330.22

BLUE CROSS

- Hospital Costs 10,340.03

BOARD OF DIRECTORS

- Designated Funds 10,160.11; 10,250.020;
10,250.029; 10,250.104, 10,250.120
- Municipal Bond Funds 10,260.11; 10,260.16
- Nonprofit Organizations 10,250.008,
10,250.030; 10,250.049

BONDS

- Disclosure of Ratings 10,260.27
- Discounts—See Debt Discounts
- General Obligation 10,260.06
- Industrial Development 10,260.05—.06
- Municipal—See Municipal Bonds
- Premium—See Premium on Debt

BOOK VALUE—See Carrying Amount

BORROWERS—See Debtors

BOTANICAL SOCIETIES

- Financial Statements 10,250.141

BROADCASTING STATIONS

- Financial Statements 10,250.136

BROKER/DEALERS IN SECURITIES

- Estimated Current Values of
Securities 10,350.18
- Municipal Bonds 10,260.09—.15
- Repurchase—Reverse Repurchase
Agreements 10,380.06; 10,380.14; 10,400.13

BUILDINGS

- Construction-Type Contracts 10,330.01

BUSINESS COMBINATIONS

- Real Estate Ventures 10,240.27

BUSINESS ENTERPRISES

- Contract Costs 10,330.71—.72
- Personal Financial Statements—See
Personal Financial Statements
- Real Estate Investments 10,060.03;
10,240.01—.41
- Sources of Support 10,250.027
- Types of Contracts 10,330.01, 10,330.12—.15;
10,330.93

**CALL OPTIONS—See Put and Call
Options**

**CALL OR REDEMPTION—See
Redemption or Call**

CAPITAL ADDITIONS

- Deferred 10,250.052; 10,250.121
- Definition 10,250.126
- Investment Income 10,250.072—.073
- Nonprofit Organizations 10,250.025—.031,
10,250.034; 10,250.050—.053

CAPITAL CONTRIBUTIONS

- Form v. Substance 10,240.30—.34
- Real Estate Ventures 10,240.29—.32
- REIT Adviser's Operating Support
10,060.49—.50

CAPITAL GAINS DISTRIBUTION

- Money-Market Funds 10,140.06—.07

CAPITALIZED INTEREST

- FASB Project 10,240.35
- Real Estate Construction 10,240.34—.35

CAPTIVE INSURANCE COMPANIES

- Medical Malpractice Claims 10,410.16,
10,410.19; 10,410.54—.65

CARRYING AMOUNT

- Cost Method of Carrying
Investments 10,240.08
- Investments, Nonprofit
Organizations 10,250.025; 10,250.077—.083;
10,250.116—.117
- Marketable Equity Securities 10,160.03—
08; 10,160.12—.14
- Real Estate Ventures 10,240.26—.28;
10,240.38
- REIT Loans 10,060.17, 10,060.29C, 10,170.02,
10,170.06

CASH

- Defined as Asset 10,020.10
- Expenditure by Function 10,020.02,
10,020.06
- Real Estate Ventures 10,240.19; 10,240.25,
10,240.29—.31
- Troubled Debt Restructuring 10,060.29A;
10,170.03, 10,170.06

CASH BASIS ACCOUNTING

- Construction-Type Contracts 10,330.06
- Nonprofit Organizations 10,250.002,
10,250.011—.013
- Personal Financial Statements 10,350.07;
10,350.31

CEMETERY ORGANIZATIONS

- Financial Statements 10,250.130

**CHANGES, ACCOUNTING—See
Accounting Changes****CHARTS OF ACCOUNTS**

- Colleges and Universities 10,020.12

CLAIMS

- Back Charges on Contracts 10,330.77
- Contracts . . . 10,330.54, 10,330.63; 10,330.65—67, 10,330.77
- Legal Requirements 10,330.65
- Medical Malpractice Claims—See
Medical Malpractice Claims
- Undivided Interests 10,240.18—19

CLASSIFICATION OF ACCOUNTS

- Colleges and Universities 10,020.01—12
- Functional—See Functional
Classification
- Losses on Contracts 10,330.89
- Marketable Equity Securities . . . 10,160.05—06
- Medical Malpractice Claims 10,410.28, 10,410.72—73
- Nonprofit Organizations 10,250.023—024, 10,250.035
- Object Classifications 10,250.088; 10,250.126
- Personal Financial Statements . . . 10,350.08

CLOSED END INVESTMENT COMPANIES

- Registration Fees 10,140.41

CLUBS

- Donated Services 10,250.067
- Financial Statements 10,250.131

COLLATERAL SECURITY

- Assets Pledged 10,250.105
- Obligations of ESOPs 10,130.02
- Options 10,140.27—29
- Real Estate Loans . . . 10,060.10—12; 10,240.19, 10,240.34

COLLECTION OF RECEIVABLES

- Interest Revenue Recognition
- Discontinued 10,060.30—38
- Pledges 10,250.064
- Real Estate Loans 10,240.34
- REIT Loans 10,060.53—54

COLLECTIONS

- Definition 10,250.126
- Nonprofit Organizations 10,250.113—115

COLLECTIVE TRUST FUNDS

- Applicability of Investment Company
Guide 10,140.03

**COLLEGE AND UNIVERSITY BUSINESS
ADMINISTRATION**

- Publication of American Council on
Education 10,020.02—05

COLLEGES AND UNIVERSITIES

- Accounting Policies 10,020.11
- Chart of Accounts 10,020.12
- Current Funds 10,020.10
- Effective Date of Statement 10,020.09
- Fundamental Accounting Principle . . 10,020.02
- Illustrative Exhibits 10,020.11
- Interfund Transfers 10,020.10—12
- Joint Accounting Group 10,020.03—06
- Notes to Financial Statements 10,020.11
- Proposed Amendment to Audit
Guide 10,020.01—12
- Restricted Funds 10,250.057

COMBINED FINANCIAL STATEMENTS

- Hospital-Related Organizations . . . 10,340.03—05, 10,340.08, 10,340.10—11, 10,340.16
- Nonprofit Organizations 10,250.042—048

COMMISSIONS

- Personal Financial Statements 10,350.12

COMMITMENT FEES

- Definition 10,060.39
- Real Estate Investment Trusts 10,060.39—46
- Revenue Recognition 10,060.41—46

COMMITMENTS

- Disclosure 10,250.012
- Employer Contributions to ESOP 10,130.02; 10,130.05, 10,130.09
- Fees—See Commitment Fees
- Grants 10,250.102
- Personal Financial Statements 10,350.28
- Real Estate Investment Trusts 10,060.05, 10,060.39—46
- Real Estate Ventures 10,240.15—20

COMMON STOCK

- Real Estate Ventures 10,240.05

**COMPARATIVE FINANCIAL
STATEMENTS**

- Bank's Investment Securities Gains or
Losses 10,360.18
- Nonprofit Organizations 10,250.041, 10,250.128
- Personal Financial Statements 10,350.06, 10,350.33

COMPENSATION—See Personnel Costs**COMPLETED-CONTRACT METHOD**

- Accounting Changes 10,330.90—91
- Accounting Policies . . . 10,330.31—32, 10,330.52
- Applicability of Method 10,330.04—05
- Billings on Contracts 10,330.30
- Change Orders 10,330.62, 10,330.87
- Completion Criteria 10,330.52
- Consistency 10,330.52
- Deferred Costs 10,330.30, 10,330.62
- Definition 10,330.04
- Disclosure Requirements 10,330.52, 10,330.90—91
- Estimation 10,330.30—33
- Financial Position 10,330.31
- Financial Statements . . . 10,330.30, 10,330.90—91

General and Administrative Costs

- General and Administrative Costs . . 10,330.72; 10,330.87
- Income Statements 10,330.33
- Loss Recognition 10,330.85—89
- Matching Principle . . . 10,330.30—31, 10,330.72
- Materiality 10,330.31
- Results of Operations 10,330.31
- Revenue Recognition . . . 10,330.30—31, 10,330.71
- Rights of Contracting Parties 10,330.30
- Statements of Financial Position . . . 10,330.30
- Time Periods 10,330.30—31
- Use of Method 10,330.25, 10,330.30—33

COMPTROLLER OF THE CURRENCY

- Regulation 9 10,140.03

COMPUTER SOFTWARE

- Production-Type Contracts 10,330.01

CONFIRMATIONS

- Pricing of Securities 10,260.19—20

CONSISTENCY

- Bank's Investment Securities Gains or
Losses 10,360.16
- Completed-Contract Method 10,330.52
- Generally Accepted Accounting
Principles 10,360.16
- Municipal Bond Funds 10,260.10—12
- Nonprofit Organizations 10,250.006
- Percentage of Completion Method . . 10,330.45, 10,330.68, 10,330.78—81
- Personal Financial Statements 10,350.15

CONSOLIDATED FINANCIAL STATEMENTS

Hospital-Related Organizations 10,340 08,
10,340 10—11, 10,340 16
Real Estate Ventures 10,240 05—07,
10,240 21

CONSTRUCTION IN PROGRESS

Capitalized Interest 10,240 34—35
Estimates on Contracts 10,330 02,
10,330 43—51, 10,330 78

CONSTRUCTION LOANS

Definition 10,060 04
Illustration of REIT Accounting 10,060 53

CONSTRUCTION-TYPE CONTRACTS

Accounting Policies 10,330 02, 10,330 21
Allocation of Costs 10,330 02, 10,330 06,
10,330 69—72, 10,330 87
Alternative Accounting Principles
10,330 05—06, 10,330 21
Billings on Contracts 10,330 06
Buildings 10,330 01
Cash Basis Accounting 10,330 06
Combining Contracts 10,330 34—38,
10,330 64
Completed Contracts—See
Completed-Contract Method
Effective Date 10,330 91
Estimation 10,330 02, 10,330 04—05
Expenses 10,330 02
Generally Accepted Accounting
Principles 10,330 01, 10,330 10—11,
10,330 18—19, 10,330 72
Illustrative Chart 10,330 92
Industry Practices 10,330 05—06
Loss Recognition 10,330 24—25, 10,330 37,
10,330 85—89
Percentage of Completion—See
Percentage of Completion Method
Precontract Costs 10,330 73—75
Profit Centers 10,330 34—42
Realization Principle 10,330 03
Segmenting Contracts 10,330 34,
10,330 39—42, 10,330 85
Specifications by Customers 10,330 01,
10,330 11—16
Time Periods 10,330 02
Transition 10,330 90—91

CONSUMERS

Service Contracts 10,330 14

CONTINGENCIES

Claims by Contractor 10,330 67
Losses on Real Estate Ventures 10,240 19
Medical Malpractice Claims 10,410 10,
10,410 29
Personal Financial Statements 10,350 32

CONTRACTORS

Accountability 10,330 26
Agency Relationships 10,330 58—60
Audit Guides (AICPA) 10,330 04, 10,330 18—
19, 10,330 72, 10,330 93
Back Charges on Contracts 10,330 76—77
Bids on Contracts 10,330 27
Change Orders 10,330 61—63, 10,330 87
Claims 10,330 54, 10,330 63, 10,330 65—67,
10,330 77
Definition 10,330 16
Disclosure Requirements 10,330 94
Liens 10,330 22
Loss Recognition 10,330 24—25, 10,330 37,
10,330 85—89
Rights 10,330 22—23
Risk 10,330 58—60

CONTRACTS

Additions 10,330 64
Alternative Accounting Principles
10,330 05—06, 10,330 21

CONTRACTS—continued

Back Charges 10,330 76—77
Bids by Contractors 10,330 27
Change Orders 10,330 61—64, 10,330 87
Claims 10,330 54, 10,330 63, 10,330 65—67,
10,330 77
Colleges and Universities 10,020 10
Combining Contracts 10,330 34—38,
10,330 64
Construction—See Construction-Type
Contracts
Cost Type—See Cost-Type Contracts
Costs 10,330 68—78
Definition 10,330 12
Effective Date 10,330 91
Fees 10,330 54—60
Financing 10,330 22
Fixed Price—See Fixed Price Contracts
Government 10,330 07—08, 10,330 57,
10,330 72
Hospitals 10,340 09
Illustrative Chart 10,330 92
Income Taxes 10,330 09
Insurance—See Insurance
Interest Costs 10,330 72
Inventory Costing Methods 10,330 69—72
Life Income Agreement 10,250 126
Losses 10,330 24—25, 10,330 37, 10,330 88
Measurement of Progress 10,330 43—
52, 10,330 79—84
Options 10,330 54, 10,330 64
Performance—See Performance on
Contracts
Pricing 10,330 15, 10,330 54—59, 10,330 78,
10,330 93
Production—See Production-Type
Contracts
Profit Centers 10,330 17, 10,330 34—42
Program Accounting 10,330 14, 10,330 75
Real Estate Ventures 10,240 01—41
Repurchase Agreements—See
Repurchase—Reverse Repurchase
Agreements
Reverse Repurchase Agreements—See
Repurchase—Reverse Repurchase
Agreements
Scope of Section 10,330 11—20
Segmenting Contracts 10,330 34,
10,330 39—42, 10,330 85
Short v. Long-Term 10,330 11, 10,330 31
Time and Material—See Time-and-
Material Contracts
Transition 10,330 90—91
Types of Contracts 10,330 01, 10,330 12—15,
10,330 93
Unit Price—See Unit Price Contracts

CONTRIBUTIONS

Collections As Agents 10,250 090
Facilities 10,250 071, 10,250 105
Future Periods 10,250 095
General Public Support 10,250 085
Hospital-Related Organizations
10,340 01—03, 10,340 12
Materials 10,250 071
Nonprofit Organizations 10,250 028—029,
10,250 033, 10,250 044, 10,250 049, 10,250 084
Services 10,250 067—070

CONTROL

Contract Estimation 10,330 26
Definition 10,240 05, 10,250 042
Hospital-Related Organizations 10,340 05,
10,340 08—12
Nonprofit Organizations 10,250 009,
10,250 042—048, 10,250 067—069
Partnerships 10,240 07—11
Pricing Municipal Bonds 10,260 14—15
Real Estate Ventures 10,240 07—11,
10,240 21

COOPERATIVES

- Agricultural—See Agricultural Cooperatives
- Definition 10,390.010

COST ACCOUNTING STANDARDS**BOARD**

- Capital Assets Defined 10,020.10
- Governmental Regulation 10,330.08

COST METHOD OF CARRYING**INVESTMENTS**

- Hospitals 10,160.03—04
- Limited Partnerships 10,240.08

COST OF CAPITAL

- Real Estate Investment Trusts 10,060.21,
10,060.53—54

COST PRINCIPLE

- Business Enterprises 10,330.71—72
- Fixed Assets 10,250.105
- Government Contracts 10,330.08
- Investments 10,250.077
- Real Estate Ventures 10,240.30

COST-TYPE CONTRACTS

- Contract Costs 10,330.72
- Definition 10,330.15; 10,330.93
- Description of Types 10,330.93
- Estimation of Revenue 10,330.57—59
- Government Contracts 10,330.57
- Loss Recognition 10,330.86

COSTS

- Allocation—See Allocation of Costs
- Back Charges 10,330.76—77
- Billings on Contracts 10,330.69
- Claims By Contractors 10,330.65—67
- Colleges and Universities 10,020.10
- Combined Financial Statements 10,250.043
- Cost-Type Contracts 10,330.72
- Deferred—See Deferred Costs
- Depreciation—See Depreciation
- Development Costs—See Development Costs
- Estimation 10,330.02; 10,330.23—29;
10,330.44—51; 10,330.69
- Fund-Raising—See Fund-Raising Activities
- Historical—See Historical Costs
- Interest—See Interest Costs
- Management 10,250.091—092
- Materials 10,330.69; 10,330.72
- Nonprofit Organizations 10,250.007,
10,250.027
- Patient Care 10,340.03
- Percentage of Completion Method 10,330.68—84
- Period Costs 10,330.70
- Precontract 10,330.73—75
- Printing Prospectuses 10,140.44
- Properties Acquired in Debt Restructuring 10,060.29A; 10,170.06
- Real Estate—See Real Estate
- Registration Fees 10,140.44
- Reimbursable 10,330.57—60; 10,330.76—77,
10,330.86
- Service Departments 10,020.10

CREDIT UNIONS

- Repurchase—Reverse Repurchase Agreements 10,400.14

CREDITORS

- Investors in Real Estate Ventures 10,240.18
- Nonprofit Organizations 10,250.008
- Restructuring of Debt 10,060.29C; 10,170.03,
10,170.06

CUBA—See College and University Business Administration**CURRENT ASSETS**

- Nonprofit Organizations 10,250.023—024

CURRENT FUNDS

- Colleges and Universities 10,020.10
- Marketable Equity Securities 10,160.05—09; 10,160.17
- Revenues 10,020.10
- Terminology 10,020.10

CURRENT LIABILITIES

- Losses on Contracts 10,330.89
- Nonprofit Organizations 10,250.023—024

CUSTODIAN FUNDS

- Definition 10,250.126
- Nonprofit Organizations 10,250.083,
10,250.123

CUSTOMERS

- Change Orders 10,330.61—63
- Claims By Contractors 10,330.65—67
- Combining Contracts 10,330.37—38
- Materials Furnished By Customers 10,330.60
- Segmenting Contracts 10,330.39—40
- Specifications in Contracts 10,330.01,
10,330.11—16

DATA PROCESSING

- Matrix Pricing 10,260.18

DEACCESSIONS

- Definition 10,250.126
- Nonprofit Organizations 10,250.114

DEBT—See Liabilities**DEBT DISCOUNTS**

- Municipal Bonds 10,260.30—31
- Personal Financial Statements 10,350.27—29

DEBT RESTRUCTURING—See Restructuring of Debt**DEBTORS**

- Commitment Fees 10,060.39
- Default on REIT Loans 10,060.07,
10,060.10—12; 10,060.35; 10,060.53—54,
10,170.01—06
- Municipalities 10,260.01—40
- Restructuring of Debt 10,060.29B; 10,170.03,
10,170.06

DEFAULT

- Municipal Bonds 10,260.21—25
- REIT Loans 10,060.07; 10,060.10—13,
10,060.29A—29C; 10,060.35; 10,060.53—54,
10,170.01—06

DEFENSE ACQUISITION REGULATION

- Governmental Accounting 10,330.08

DEFERRED COSTS

- Colleges and Universities 10,020.10
- Completed-Contract Method 10,330.30;
10,330.62
- Defined as Assets 10,020.10
- Fund-Raising Activities 10,250.095
- Investment Companies 10,140.02,
10,140.44—45
- Precontract Costs 10,330.73—75

DEFERRED CREDITS

- Call Option Premiums 10,140.28
- Colleges and Universities 10,020.10
- Defined as Liabilities 10,020.10

DEFERRED INCOME

- Commitment Fees 10,060.42—46
- Contributions 10,250.095
- Interest Income 10,240.34
- Investment Income 10,250.073
- Nonprofit Organizations 10,250.034
- Origination Fees 10,140.14
- Pledges 10,250.065

DEFERRED INCOME—continued

Real Estate Ventures	10,240.34
Restricted Funds	10,250.021; 10,250.029, 10,250.057, 10,250.062, 10,250.121

DEFINITIONS—See Terminology

DELAYED RECOGNITION METHOD

Commitment Fees	10,060.42
-----------------	-----------

DEPRECIATION

Allocation of Costs	10,250.106—107, 10,250.127
Definition	10,250.106
Fixed Assets	10,250.106—112
Real Estate	10,240.30
Real Estate Ventures	10,240.25, 10,240.27— 28

DESIGNATED FUNDS

Definition	10,250.126
Interfund Transactions	10,160.11, 10,250.104
Nonprofit Organizations	10,250.020, 10,250.029, 10,250.120

DEVELOPMENT

Costs—See Development Costs
Loans—See Development Loans
Stage—See Development Stage Enterprises

DEVELOPMENT COSTS

Agricultural Producers	10,390.040—062
Definition	10,390.002
Intermediate-Life Plants	10,390.043, 10,390.049, 10,390.056, 10,390.060
Land	10,390.041, 10,390.046—047, 10,390.051— 053, 10,390.059—060
Livestock	10,390.044, 10,390.050, 10,390.057— 058, 10,390.061—062
Trees and Vines	10,390.042, 10,390.048, 10,390.054—055, 10,390.060

DEVELOPMENT LOANS

Definition	10,060.04
Illustration of REIT Accounting	10,060.53

DEVELOPMENT STAGE ENTERPRISES

Generally Accepted Accounting Principles	10,140.43
Investment Companies	10,140.38—43
REIT Construction Loan	10,060.53

DIRECTORS—See Board of Directors

DISCLOSURE

Accessions	10,250.114
Accounting Changes	10,330.90—91, 10,360.16
Accounting Policies	10,330.21, 10,330.25, 10,330.31
Assets Pledged	10,250.105
Bank's Investment Securities Gains or Losses	10,360.16
Combined Financial Statements	10,250.044 10,250.012
Commitments	10,330.52, 10,330.90—91
Completed-Contract Method	10,330.94
Contractors	10,250.049
Contributions	10,250.114
Deaccessions	10,250.110
Depreciation	10,250.070
Donated Services	10,130.05, 10,130.10, 10,130.15
Employee Stock Ownership Plans	10,250.102
Grants	10,340.04—05, 10,340.10—12, 10,340.16
Hospital-Related Organizations	10,130.05, 10,130.10, 10,130.15
Informative—See Informative Disclosure	
Interest Revenue Recognition	10,060.37—38
Discontinued	

DISCLOSURE—continued

Interfund Borrowings	10,250.118—119
Marketable Equity Securities	10,160.03, 10,160.07, 10,160.11—16
Medical Malpractice Claims	10,410.12, 10,410.18, 10,410.22; 10,410.29—32, 10,410.52— 53, 10,410.64—65, 10,410.75
Mortgage-Backed Securities	10,400.31
Municipal Bond Funds	10,260.20; 10,260.25— 28, 10,260.31; 10,260.40
Nonprofit Organizations	10,250.028, 10,250.035—041, 10,250.044, 10,250.047, 10,250.076—082, 10,250.100, 10,250.125; 10,250.128—141
Options Written	10,140.28—29
Pass-Through Securities	10,400.31
Percentage of Completion Method	10,330.45, 10,330.82—84, 10,330.90—91
Personal Financial Statements	10,350.21, 10,350.31
Pledges Receivable	10,250.065—066
Real Estate Investment Trusts	10,060.23, 10,060.28, 10,060.29C, 10,060.37—38, 10,170.06
Real Estate Ventures	10,240.06, 10,240.12— 13, 10,240.41
REIT Adviser's Operating Support	10,060.48, 10,060.52
Repurchase—Reverse Repurchase Agreements	10,400.03, 10,400.11—17, 10,400.25—27, 10,400.31
Restricted Funds	10,250.015, 10,250.062
Savings and Loan Associations	10,400.34
Subsequent Events	10,330.82
Unsolicited Merchandise	10,250.092—093
"When Issued" Securities	10,260.20

DISCOUNT ON DEBT—See Debt Discounts

DISCOUNTING—See Time Value of Money

DIVIDENDS

Distribution Policies	10,140.06—07
Money-Market Funds	10,140.06—16
Municipal Bond Funds	10,260.29, 10,260.33— 38
Nonprofit Organizations	10,250.072—076
Shares Held by ESOP	10,130.12—13

DOLLAR REPURCHASE—DOLLAR

REVERSE REPURCHASE AGREEMENTS

Accounting by Sellers—Borrowers	10,380.18—39
Breakage	10,380.25—28, 10,380.36
Control of Asset	10,380.17—19
Definitions	10,380.07—08
Fixed Coupon Agreements	10,380.08—10; 10,380.20—21, 10,380.29—32, 10,380.35
Illustrations	10,380.39
Rollovers and Extensions	10,380.24, 10,380.35
vs Repurchase—Reverse Repurchase Agreements	10,380.15—17, 10,400.05
Yield Maintenance Agreements	10,380.08—10, 10,380.22—23, 10,380.29; 10,380.33—34, 10,400.05

DONATIONS—See Contributions

EARNINGS PER SHARE

Money-Market Funds	10,140.14
Shares Held by ESOP	10,130.11—13

EMPLOYEE BENEFIT PLANS

Nonprofit Organizations	10,250.005
-------------------------	------------

EMPLOYEE RETIREMENT INCOME

SECURITY ACT OF 1974

Description of ESOP	10,130.01
---------------------	-----------

EMPLOYEE STOCK OWNERSHIP PLANS

Assets	10,130.06
--------	-----------

EMPLOYEE STOCK OWNERSHIP**PLANS**—continued

Compensation Expense	10,130.09—13
Debt Guaranteed by Employer	10,130.02
Description	10,130.01
Disclosure Requirements	10,130.05,
	10,130.10, 10,130.15
Dividends	10,130.12—13
Earnings Per Share	10,130.11—13
Employer Contributions	10,130.01—15
Financial Statements of Employer	10,130.05—08
Income Taxes	10,130.02, 10,130.04,
	10,130.14—15
Interest Costs	10,130.02, 10,130.10
Investment Tax Credit	10,130.01, 10,130.14
Investments in Employer's Securities	10,130.01—02
Liabilities Incurred to Buy Securities	10,130.02—03
Timing Differences	10,130.15

EMPLOYEES

Nonprofit Organizations	10,250.049,
	10,250.067—069

EMPLOYER CONTRIBUTIONS

Employee Stock Ownership Plans	10,130.01—15
--------------------------------	--------------

EMPLOYERS

Nonprofit Organizations	10,250.067—069
-------------------------	----------------

ENCUMBRANCES—See **Commitments****ENDOWMENT FUNDS**

Colleges and Universities	10,020.10—12
Definition	10,250.126
Interfund Borrowings	10,250.118—119
Investment Income	10,250.073—076
Investments	10,160.10—11
Nonprofit Organizations	10,250.026—028
Quasi-Endowment Funds	10,250.126
Restricted Funds	10,250.021, 10,250.051
Term Endowments	10,250.104, 10,250.126
Total Return Approach	10,250.075—076,
	10,250.104

EQUITY METHOD OF ACCOUNTING

Real Estate Ventures	10,240.04—28
----------------------	--------------

ERRORS

Pricing Municipal Bonds	10,260.14
-------------------------	-----------

ESOP—See **Employee Stock Ownership Plans****ESTIMATED CURRENT AMOUNT OF LIABILITIES**

Definition	10,350.27
Personal Financial Statements	10,350.04,
	10,350.11—13, 10,350.15, 10,350.27—31

ESTIMATED CURRENT VALUE OF ASSETS

Personal Financial Statements	10,350.02—04,
	10,350.06, 10,350.10—26, 10,350.31

ESTIMATION

Amortization of Mortgage Bank Loans	10,020.20
Back Charges on Contracts	10,330.77
Change in Estimate	10,330.19, 10,330.25,
	10,330.82—84
Claims by Contractors	10,330.65
Completed-Contract Method	10,330.30—33
Construction-Type Contracts	10,330.02,
	10,330.04—05
Costs of Estimating	10,330.69
Costs to Complete	10,330.78
Current Amount of Liabilities—See Estimated Current Amount of Liabilities	

ESTIMATION—continued

Current Values of Assets—See Estimated Current Value of Assets	
Forecasting—See Forecasting	
Losses From Loans	10,060.13—23, 10,170.02
Losses From Medical Malpractice Claims	10,410.11, 10,410.22—27
Net Realizable Value of Foreclosed Property	10,170.02
Nonprofit Organizations	10,250.100
Percentage of Completion Method	10,330.23—29, 10,330.43—51, 10,330.68—84
Pledges Receivable	10,250.064—066
Production-Type Contracts	10,330.02—05
Reliability	10,330.26—29, 10,330.65
Revenue	10,330.04, 10,330.23—29, 10,330.53—67
Selling Price of Property	10,060.53—54,
	10,170.02
Useful Life	10,250.106, 10,250.112

EVENTS

Fund-Raising Activities	10,250.093
Percentage of Completion Method	10,330.53
Receipt of Restricted Funds	10,250.059

EVIDENTIAL MATTER

Losses on Real Estate Ventures	10,240.19
--------------------------------	-----------

EXPENDITURES

Capital Assets	10,020.10
Classification by Function	10,020.02,
	10,020.06

EXPENSES

Compensation—See Personnel Costs	
Construction-Type Contracts	10,330.02
Donated Facilities	10,250.071
Donated Materials	10,250.071
Donated Services	10,250.067
Functional—See Functional Classification	
Grants	10,250.101—102
Investment Companies	10,140.02,
	10,140.38—43
Municipal Bond Funds	10,260.34, 10,260.39
Net Loss on Debt Restructuring	10,060.29C, 10,170.06
Nonprofit Organizations	10,250.025—031,
	10,250.058—062, 10,250.085—104
Object Classification	10,250.088, 10,250.126
Personal Financial Statements	10,350.06
Precontract Costs	10,330.74—75
Production-Type Contracts	10,330.02
Real Estate Ventures	10,240.25, 10,240.28
Recognition Principles	10,330.70
Research and Development Costs	10,330.74

EXTRAORDINARY ITEMS

Gain on Troubled Debt Restructuring	10,060.29C, 10,170.06
-------------------------------------	-----------------------

FACE AMOUNT

Life Insurance Disclosure	10,350.21,
	10,350.31

FACE-AMOUNT CERTIFICATE COMPANIES

Definition	10,030.02—06
Description of Business	10,030.07—08

FACE-AMOUNT CERTIFICATES

Definition	10,030.03
------------	-----------

FACILITIES

Construction-Type Contracts	10,330.01,
	10,330.11
Percentage of Completion Method	10,330.22

FAIR PRESENTATION

- Municipal Bond Funds 10,260.17
- Nonprofit Organizations 10,250.042

FAIR VALUE

- Assets Received in Debt Restructuring 10,060.29A, 10,170.03; 10,170.06
- Assets Transferred in Debt Restructuring 10,060.29A; 10,170.03; 10,170.06
- Equity Interest Issued in Debt Restructuring 10,170.03
- Facilities Donated 10,250.071, 10,250.105
- Investments Donated 10,250.077
- Investments, Nonprofit Organizations 10,250.077—082
- Investments, Short-Term 10,140.46
- Materials Donated 10,250.071
- Municipal Bonds 10,260.10; 10,260.16—18; 10,260.23
- Options 10,140.33
- Over-the-Counter Securities 10,260.10
- Real Estate Ventures 10,240.14, 10,240.19; 10,240.27
- Regulated Investment Companies 10,240.03

FARMERS—See Agricultural Producers

FASB—See Financial Accounting Standards Board

FEDERAL HOME LOAN MORTGAGE CORP.

- Mortgage-Backed Securities 10,380.02—04, 10,400.07
- Mortgage Participation Certificates 10,380.03—04, 10,380.10

FEDERAL PROCUREMENT REGULATION

- Governmental Accounting 10,330.08

FEES

- Colleges and Universities 10,020.10
- Commitment—See Commitment Fees
- Contracts 10,330.54—60
- Membership—See Membership Fees
- Pricing Services 10,260.13—15
- Registration—See Registration Fees
- REIT Advisers 10,060.47—52

FELLOWSHIPS—See Scholarships and Fellowships

FINANCIAL ACCOUNTING STANDARDS BOARD

- Capitalization of Interest 10,240.35
- Nonbusiness Organizations Project 10,250.124
- Personal Financial Statements 10,350.32
- Service Transactions 10,330.11
- Statement No. 2 10,330.74
- Statement No. 5 10,240.19; 10,330.67
- Statement No. 7 10,140.38; 10,140.43
- Statement No. 12 10,160.01; 10,160.03; 10,240.05
- Statement No. 15 10,060.13; 10,060.29A—29C; 10,170.01, 10,170.03—06
- Statement No. 34 10,330.72

FINANCIAL POSITION

- Bank's Investment Securities Gains or Losses 10,360.16
- Completed-Contract Method 10,330.31
- Nonprofit Organizations 10,250.017
- Percentage of Completion Method 10,330.31

FINANCIAL STATEMENTS

- Agricultural Cooperatives 10,390.105; 10,390.107
- Assets and Liabilities—See Statements of Assets and Liabilities

FINANCIAL STATEMENTS—continued

- Balance Sheets—See Statements of Financial Position
- Banks 10,360.01—18
- Botanical Societies 10,250.141
- Broadcasting Stations 10,250.136
- Cemetery Organizations 10,250.130
- Changes in Financial Position—See Statements of Changes in Financial Position
- Changes in Fund Balances—See Statements of Changes in Fund Balances
- Changes in Net Assets—See Statements of Changes in Net Assets
- Clubs 10,250.131
- Colleges and Universities 10,020.11
- Combined—See Combined Financial Statements
- Comparative—See Comparative Financial Statements
- Completed-Contract Method 10,330.30; 10,330.90—91
- Disclosure—See Disclosure
- Format for Nonprofit Organizations 10,250.036—041
- Foundations 10,250.135
- Fund Accounting 10,250.014—015
- Health Care Entities 10,370.25
- Hospital-Related Organizations 10,340.01—16
- Income—See Income Statements
- Interest Revenue Recognition Discontinued 10,060.38
- Interim—See Interim Financial Statements
- Investment Securities Gains or Losses 10,360.01—18
- Libraries 10,250.132
- Loan Loss Allowances 10,060.13; 10,060.29A—29C, 10,060.35; 10,170.02; 10,170.06
- Marketable Equity Securities 10,160.03—17
- Medical Malpractice Claims 10,410.21—29; 10,410.62
- Municipal Bond Funds 10,260.17, 10,260.20; 10,260.25—28; 10,260.31, 10,260.40
- Museums 10,250.133
- Nonprofit Organizations 10,250.008—011; 10,250.016—041, 10,250.078—083; 10,250.100; 10,250.125
- Obligations of ESOPs 10,130.05—08
- Operations—See Statements of Operations
- Percentage of Completion Method 10,330.22, 10,330.90—91
- Performing Arts Organizations 10,250.134
- Personal—See Personal Financial Statements
- Prior Periods' 10,360.16—18
- Real Estate Ventures 10,240.03—06; 10,240.12—16; 10,240.24, 10,240.41
- REIT Debt Restructuring 10,060.29A—29C; 10,170.06
- Religious Organizations 10,250.048; 10,250.137
- Repurchase—Reverse Repurchase Agreements 10,400.31
- Research Organizations 10,250.138
- Revenue and Expense—See Statements of Revenue and Expense
- Savings and Loan Associations 10,400.34
- Schools 10,250.129
- Scientific Organizations 10,250.138
- Statements of Activity—See Statements of Activity
- Trade Associations 10,250.139
- Unions 10,250.140

FINANCIAL STATEMENTS—continued

Zoological Societies 10,250 141

FINANCING

Contracts 10,330 22

Fixed Coupon Dollar Agreements
10,380 20—21, 10,380 30—32

Health Care Entities 10,370 01—25

Municipal Bonds 10,260 04—07

Municipal Notes 10,260 08

Nonprofit Organizations 10,250 033—034,
10,250 044, 10,250 111

Real Estate Investment Trust 10,060 06

Real Estate Ventures 10,240 07, 10,240 11,
10,240 20**FIXED ASSETS**

Depreciation 10,250 106—112

Nonprofit Organizations 10,250 105—112

Pledges Receivable 10,250 066

Resources Restricted for

Acquisitions 10,250 021, 10,250 052

Valuation 10,250 105

FIXED PRICE CONTRACTS

Definition 10,330 15, 10,330 93

Description of Types 10,330 93

Estimation of Revenue 10,330 56

FOOTNOTES—See Notes to Financial Statements**FORECLOSURE**

Interest Revenue Recognition

Discontinued 10,060 31, 10,060 35

Real Estate Investment Trusts 10,060 10—

13, 10,060 17, 10,060 26—28, 10,060 35,

10,060 53—54, 10,170 01—06

FORM V. SUBSTANCE

Capital Contributions 10,240 30—34

Hospital Resources 10,340 04

Real Estate Ventures 10,240 02, 10,240 07—

10, 10,240 25, 10,240 37

Sales 10,240 30

FOUNDATIONS

Financial Statements 10,250 135

Grants 10,250 096

Hospital-Related—See Hospital-

Related Organizations

Sources of Support 10,250 027

FUNCTIONAL CLASSIFICATION

Allocation of Costs 10,250 091, 10,250 096—

100, 10,250 127

Colleges and Universities 10,020 10

Definition 10,250 126

Fund-Raising Activities 10,250 094

Nonprofit Organizations 10,250 025,

10,250 085—089

FUND ACCOUNTING PROCEDURES

Colleges and Universities 10,020 10—12

Current v. Noncurrent

Classification 10,250 023—024

Marketable Equity Securities 10,160 05—

17

Nonprofit Organizations 10,250 014—015,

10,250 035

FUND BALANCES

Changes—See Statements of Changes

in Fund Balances

Nonprofit Organizations 10,250 019—022,

10,250 055—057, 10,250 062, 10,250 080,

10,250 120

FUND-RAISING ACTIVITIES

Allocation of Costs 10,250 092—098

Hospital-Related Organizations 10,340 01—02, 10,340 09, 10,340 12

Nonprofit Organizations 10,250 067—069,

10,250 085—087

FUNDING—See Financing**FUNDS (ENTITIES)**

Definition 10,250 126

Endowment—See Endowment Funds

Fund Groups 10,250 036—041

General 10,370 07—23

Health Care Entities 10,370 04—05

Interrelated Organizations 10,250 042—048

Municipal Bond Funds 10,260 01—40

Nonprofit Organizations 10,250 014—015

Restricted 10,370 07—10, 10,370 18—19,

10,370 23

Use Limited 10,370 04—06, 10,370 15

FUTURE PRICE

Costs to Complete 10,330 78

GAINS

Bank's Investment Securities 10,360 01—

18

Extraordinary Items 10,060 29C, 10,170 06

Intercompany Transactions 10,240 07

Investments, Nonprofit

Organizations 10,250 028—029, 10,250 051,

10,250 072—083, 10,250 104, 10,250 116—117

Marketable Equity Securities 10,160 02,

10,160 09—13

Money-Market Funds 10,140 18—20

Options 10,140 30—31, 10,140 35—37

Real Estate Ventures 10,240 39—40

Regulated Investment Companies

10,140 36—37, 10,260 29, 10,260 37

Restructuring of Debt 10,060 29C, 10,170 06

Unrealized—See Unrealized

Appreciation

GENERAL AND ADMINISTRATIVE EXPENSES

Completed-Contract Method 10,330 72,

10,330 87

Nonprofit Organizations 10,250 069,

10,250 086—087, 10,250 091, 10,250 098

GENERAL FUNDS

Definition 10,370 07—10

Health Care Entities 10,370 07—23

Hospitals 10,160 05—12, 10,340 04—05

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Agricultural Cooperatives 10,390 001

Agricultural Producers 10,390 001

Consistency 10,360 16

Construction-Type Contracts 10,330 01,

10,330 10—11, 10,330 18—19, 10,330 72

Development Stage Enterprises 10,140 43

Disclosure 10,350 31

Endowment Fund Income 10,020 10

Foreclosed Property of REITs 10,060 27

Losses on Contracts 10,330 24

Municipal Bond Funds 10,260 17

Nonprofit Organizations 10,250 002,

10,250 007, 10,250 011—013, 10,250 041—042

Personal Financial Statements 10,350 02,

10,350 31—32

Production-Type Contracts 10,330 01,

10,330 10—11, 10,330 72

Real Estate Ventures 10,240 03, 10,240 13—

14, 10,240 24—25

REIT Adviser's Operating Support 10,060 51

GENERALLY ACCEPTED AUDITING STANDARDS

Personal Financial Statements 10,350 02

GIFTS

Annuity—See Annuity Gifts

Colleges and Universities 10,020 10

Fixed Assets 10,250 105

Nonprofit Organizations 10,250 028—029,

10,250 051, 10,250 054—063

GLOSSARIES—See Terminology

GNMA—See Government National Mortgage Association

GOVERNMENT AGENCIES

- Municipal Note Guarantees 10,260.08
- Nonprofit Organizations 10,250.008
- Sources of Support 10,250.027

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

- Mortgage-Backed Securities 10,380.02—04; 10,400.07—09; 10,400.28—31
- Pass-Through Securities 10,380.02—04; 10,380.10; 10,400.07—10,400.09; 10,400.28—31

GOVERNMENTAL ACCOUNTING

- Allocation of Costs 10,330.08
- Change in Estimates 10,330.19
- Contract Costs 10,330.72
- Defense Acquisition Regulation 10,330.08
- Federal Contracts 10,330.07—08; 10,330.57
- Federal Procurement Regulation 10,330.08
- Percentage of Completion Method 10,330.19

GRANTS

- Accounting by Donee Organization 10,250.028—029; 10,250.051, 10,250.054—063
- Accounting by Donor Organization 10,250.101—102
- Colleges and Universities 10,020.10
- Costs to Solicit 10,250.096

GUARANTEES

- Delivery of Securities 10,140.27
- Municipal Notes 10,260.08

HEALTH CARE ENTITIES

- Classification of Tax-Exempt Debt 10,370.12
- Debt-Financing Agreement 10,370.05; 10,370.09; 10,370.11, 10,370.23
- Financial Statements 10,370.25
- Funds Whose Use Is Limited 10,370.04—25
- General Funds 10,370.07—23
- Indenture Agreement 10,370.13, 10,370.17—18; 10,370.23
- Interest Expense 10,370.14, 10,370.20; 10,370.23
- Investment Income 10,370.14, 10,370.20—23
- Medical Malpractice Claims 10,410.01—77
- Reporting Practices 10,370.04—25
- Restricted Funds 10,370.07—10; 10,370.18—19; 10,370.23
- Revenue Bonds 10,370.02—03
- Tax-Exempt Debt 10,370.02—25
- Third-Party Reimbursement Arrangement 10,370.06, 10,370.09; 10,370.11, 10,370.15—18, 10,370.23

HIGHER EDUCATION FINANCE MANUAL

- Project of U S Office of Education 10,020.03

HISTORICAL COST

- Fixed Assets 10,250.105; 10,250.110
- Personal Financial Statements 10,350.02—04, 10,350.13

HOSPITAL-RELATED ORGANIZATIONS

- Accounting Changes 10,340.13
- Alternative Accounting Principles 10,340.05—06
- Assets 10,340.10
- Background Information 10,340.01—06
- Combined Financial Statements 10,340.03—05, 10,340.08, 10,340.10—11, 10,340.16
- Consolidated Financial Statements 10,340.08, 10,340.10—11, 10,340.16
- Contributions 10,340.01—03, 10,340.12
- Controlled by Hospitals 10,340.05, 10,340.08—12

HOSPITAL-RELATED ORGANIZATIONS—

- continued
- Definition 10,340.09
- Disclosure Requirements 10,340.04—05; 10,340.10—12; 10,340.16
- Effective Date 10,340.13
- Financial Statements 10,340.01—16
- Fund-Raising Activities 10,340.01—02; 10,340.09, 10,340.12
- Illustrations 10,340.14—15
- Legal Status 10,340.04
- Management 10,340.09
- Materiality 10,340.11—12
- Notes to Financial Statements 10,340.10—12
- Restatements 10,340.13
- Summarization 10,340.10—11
- Transactions With Hospitals 10,340.11—12

HOSPITALS

- Assets 10,340.04—05 10,340.10
- Colleges and Universities 10,020.10
- Contracts With Related Organizations 10,340.09
- Costs of Patient Care 10,340.03
- Depreciation Funding 10,370.15
- General Funds 10,160.05—12; 10,340.04—05
- Governmental Programs 10,340.02—03
- Health Care Entities—See Health Care Entities
- Investor-Owned 10,160.01, 10,160.03
- Marketable Equity Securities 10,160.01—17
- Medical Malpractice Claims 10,410.01—77
- Not-For-Profit 10,160.04—17; 10,340.01—16
- Related Organizations—See Hospital-Related Organizations
- Restricted Funds 10,250.057
- Tax-Exempt Debt 10,370.03

ILLUSTRATIONS

- Agricultural Cooperatives 10,390.107
- Allocation of Costs 10,250.127
- Chart of Accounts for Colleges and Universities 10,020.12
- Contract Accounting 10,330.92
- Dollar Repurchase—Dollar Reverse Repurchase Agreements 10,380.39
- Financial Statements of Colleges and Universities 10,020.11
- Financial Statements of Nonprofit Organizations 10,250.128—141
- Financial Statements of Savings and Loan Associations 10,400.34
- Health Care Entities Financial Statements 10,370.25
- Hospital-Related Organizations 10,340.14—15
- Personal Financial Statements 10,350.34—35
- Real Estate Ventures 10,240.25, 10,240.30
- REIT Accounting 10,060.53—55
- Statement of Changes in Net Assets 10,140.11—12
- Taxation on Municipal Bonds 10,260.34

IMMEDIATE RECOGNITION METHOD

- Commitment Fees 10,060.42

IMPAIRMENT OF VALUE

- Marketable Securities 10,160.14—15
- Money-Market Instruments 10,140.46
- Real Estate Ventures 10,240.14, 10,240.20

INCOME STATEMENTS

- Bank's Investment Securities Gains or Losses 10,360.01—18
- Completed-Contract Method 10,330.33
- Losses on Contracts 10,330.88
- Percentage of Completion Method 10,330.33, 10,330.80—81

INCOME STATEMENTS—continued

Real Estate Ventures	10,240.06
REIT Adviser's Operating Support	10,060.52
REIT Debt Restructuring	10,060.29C, 10,170.06

INCOME TAXES

Agricultural Cooperatives	10,390.014, 10,390.017
Banks	10,360.06
Contract Accounting	10,330.09
Employee Stock Ownership Plans	10,130.02, 10,130.04, 10,130.14—15
Interest on Municipal Bonds	10,260.02, 10,260.05, 10,260.24
Money-Market Funds	10,140.20
Municipal Bond Funds	10,260.29—39
Nonprofit Organizations	10,250.103
Personal Financial Statements—See Personal Financial Statements	
Put and Call Options	10,140.34—37
Real Estate Investment Trusts	10,060.02
Real Estate Ventures	10,240.06—08, 10,240.24, 10,240.40
Securities Gains or Losses	10,360.06
Statements of Financial Condition	10,350.06, 10,350.30
Unit Investment Trusts	10,250.29
"When Issued" Securities	10,260.19

INDUSTRY AUDIT GUIDES—See Audit Guides (AICPA)**INDUSTRY PRACTICES**

Colleges and Universities	10,020.01—09
Commitment Fees of REITs	10,060.43
Construction Industry	10,330.05—06
Health Care Providers	10,410.27—28
Hospital-Related Organizations	10,340.05—06
Investment Companies	10,260.01

INFORMATIVE DISCLOSURE

Comparative Financial Statements	10,350.06
Nonprofit Organizations	10,250.091
Personal Financial Statements	10,350.06, 10,350.31

INSURANCE

Medical Malpractice Claims	10,410.01—77
Personal Financial Statements	10,350.21, 10,350.31
Portfolio Securities	10,260.21—25

INSURANCE COMPANIES

Captive—See Captive Insurance Companies	
Mutual—See Mutual Insurance Companies	

INTANGIBLE ASSETS

Depreciation	10,240.27
Personal Financial Statements	10,350.25, 10,350.31
Real Estate Ventures	10,240.27, 10,240.32

INTERCOMPANY TRANSACTIONS

Eliminations in Consolidations	10,240.07, 10,240.21—23
Hospital-Related Organizations	10,340.11

INTEREST COSTS

Capitalized—See Capitalized Interest	
Contract Costs	10,330.72
Employee Stock Ownership Plans	10,130.02, 10,130.10
Holding Costs for Property	10,060.17—24, 10,060.53—55
Municipal Bonds	10,260.02
Real Estate Ventures	10,240.34

INTEREST INCOME

Amortization of Bond Discount	10,260.31
Amortization of Bond Premium	10,260.31
Default on Interest	10,260.24
Disclosure Requirements	10,060.37—38
Nonprofit Organizations	10,250.072—076
Real Estate Ventures	10,240.33—35
Recognition Discontinued	10,060.30—38
REIT Loans	10,260.44—45
Tax-Exempt	10,260.02, 10,260.05, 10,260.24, 10,260.29, 10,260.33—36
Unit Investment Trusts	10,260.29, 10,260.35
"When Issued" Securities	10,260.20

INTEREST METHOD

Commitment Fees	10,060.46
-----------------	-----------

INTEREST RATE

Personal Financial Statements	10,350.27, 10,350.31
REIT Loans	10,060.20—24, 10,060.53—54

INTERFUND TRANSACTIONS

Board-Designated Funds	10,160.11
Colleges and Universities	10,020.10—12
Nonprofit Organizations	10,250.025, 10,250.040, 10,250.076, 10,250.082, 10,250.104, 10,250.118—119

INTERIM FINANCIAL STATEMENTS

Investment Securities of Banks	10,360.16
Real Estate Ventures	10,240.41

INTERNAL ACCOUNTING CONTROL

Pricing Municipal Bonds	10,260.15
-------------------------	-----------

INTERNAL REVENUE CODE

Agricultural Cooperatives	10,390.014, 10,390.017
Contract Accounting	10,330.09
Distribution of Taxable Income	10,140.20
Employee Stock Ownership Plans	10,130.02, 10,130.04
Long-Term Capital Gains	10,140.07
Regulated Investment Companies	10,140.36, 10,260.29—39
Section 103	10,260.05
Section 851	10,260.29
Subchapter H	10,140.03

INVENTORIES

Agricultural Cooperatives	10,390.067—086
Agricultural Producers	10,390.023—062
Colleges and Universities	10,020.10
Contract Costs	10,330.71—72
Defined as Assets	10,020.10
Precontract Costs	10,330.73—75

INVENTORY COSTING METHODS

Contract Costs	10,330.69—72
Contract Sales	10,330.14

INVESTMENT COMPANIES

Accounting Policies	10,140.45
Amendment to Industry Audit Guide	10,030.01—08, 10,140.01—46, 10,260.01—40
Closed End—See Closed End Investment Companies	
Definition Amended	10,030.01—06
Expenses During Development Stage	10,140.38—43
Management Investment Companies	10,260.02, 10,260.16
Money-Market Funds—See Money-Market Funds	
Municipal Bonds—See Municipal Bond Funds	
Open End—See Open End Investment Companies	
Options—See Put and Call Options	
Organization Costs	10,140.39—44

INVESTMENT COMPANIES—continued

Regulated—See Regulated Investment Companies

INVESTMENT COMPANY ACT OF 1940

Investment Companies Defined . . . 10,140.03
Long-Term Capital Gains . . . 10,140.07

INVESTMENT INCOME

Capital Additions . . . 10,250.073
Nonprofit Organizations . . . 10,250.027—028,
10,250.033; 10,250.051, 10,250.072—076,
10,250.103

INVESTMENT POOLS

Definition . . . 10,250.126
Hospitals . . . 10,160.08
Nonprofit Organizations . . . 10,250.116—117

INVESTMENT TAX CREDITS

Contributions to ESOPs . . . 10,130.01, 10,130.14

INVESTMENTS

Agricultural Cooperatives . . . 10,390.087—105
Bank's Securities Gains or Losses . . .
10,360.01—18
Colleges and Universities . . . 10,020.10
Defined as Assets . . . 10,020.10
Donated . . . 10,250.077
Effective Date . . . 10,360.18
Employee Stock Ownership Plans . . .
10,130.01—02
Face-Amount Certificates . . . 10,030.03
Hospitals . . . 10,160.01—17
Income—See Investment Income
Marketable Securities—See
Marketable Securities Investments
Mortgage-Backed Securities . . . 10,400.28—30
Mortgages—See Mortgage Loans
Receivable . . .
Municipal Bonds—See Municipal
Bonds
Nonprofit Organizations . . . 10,250.022,
10,250.028, 10,250.033—034, 10,250.077—083
Partnerships . . . 10,240.06—10; 10,240.32
Pass-Through Securities . . . 10,400.28—30
Personal Financial Statements—See
Personal Financial Statements
Pools—See Investment Pools
Real Estate—See Real Estate
Regulation S-X . . . 10,260.26
Valuation—See Valuation

INVESTORS

Real Estate—See Real Estate

JOINT ACCOUNTING GROUP

College and University Accounting . . .
10,020.03—06

JOINT VENTURES

Real Estate—See Real Estate Ventures

JUDGMENT

Construction-Type Contracts . . . 10,330.72
Decline in Market Value . . . 10,160.14
Estimated Current Value of Assets . . .
10,350.12, 10,350.22
Loan Recoverability . . . 10,060.31
Percentage of Completion Method . . .
10,330.47, 10,330.55
Production-Type Contracts . . . 10,330.72

LAND

Acquisition Loans . . . 10,060.04
Development Costs . . . 10,390.041, 10,390.046—
047, 10,390.051—053, 10,390.059—060

LEASES

Investment in Leased Assets . . . 10,350.24
Personal Financial Statements . . . 10,350.24

LEGAL REQUIREMENTS

Claims by Contractors . . . 10,330.65
Hospital-Related Organizations . . . 10,340.04

LEGAL REQUIREMENTS—continued

Personal Financial Statements . . . 10,350.09;
10,350.30
Pledges . . . 10,250.064
Provision for Estimated Income
Taxes . . . 10,350.30—31, 10,350.35
Real Estate Ventures . . . 10,240.02, 10,240.15—
18
Repurchase—Reverse Repurchase
Agreements . . . 10,400.24
Restricted Funds . . . 10,160.10—11, 10,250.028,
10,250.056, 10,250.075, 10,250.118
Restructuring of Debt . . . 10,170.03

LIABILITIES

Annuity Gifts . . . 10,250.121
Colleges and Universities . . . 10,020.10
Current—See Current Liabilities
Definition . . . 10,020.10
Estimated Current Amount . . . 10,350.04;
10,350.11—13, 10,350.15, 10,350.27—31
Face-Amount Certificates . . . 10,030.03,
10,030.07
General Obligation Bonds . . . 10,260.06
Grants . . . 10,250.101—102
Industrial Development Bonds . . . 10,260.05—
06
Investors in Real Estate Ventures . . .
10,240.15—18
Losses on Contracts . . . 10,330.89
Medical Malpractice Claims . . . 10,410.28
Mortgages—See Mortgage Debt
Municipal Bonds—See Municipal
Bonds
Nonprofit Organizations . . . 10,250.019—024
Obligations of ESOPs . . . 10,130.01—08
Options Written . . . 10,140.28
Partners . . . 10,240.01, 10,240.06, 10,240.15
Personal Financial Statements—See
Personal Financial Statements
Tax-Exempt—See Tax-Exempt Debt
"When Issued" Securities . . . 10,260.20

LIBRARIES

Financial Statements . . . 10,250.132

LIENS

Contractors . . . 10,330.22

LIFE INCOME FUNDS

Definition . . . 10,250.126
Nonprofit Organizations . . . 10,250.083,
10,250.121

LIMITED PARTNERSHIPS

Control . . . 10,240.08—10
Description . . . 10,240.01
Municipal Bond Funds . . . 10,260.01
Real Estate Ventures . . . 10,240.01, 10,240.08—
10

LIQUIDATION

Current v. Noncurrent Liabilities . . . 10,250.023
Real Estate Ventures . . . 10,240.25

LOAN AGREEMENTS

Construction—See Construction
Loans
Personal Financial Statements . . . 10,350.03
Real Estate Investment Trusts . . . 10,060.01—
55, 10,170.01—06
Real Estate Ventures . . . 10,240.33—35
Residential—See Residential Loans

LOAN FUNDS

Definition . . . 10,250.126
Educational Institution . . . 10,020.11—12
Nonprofit Organizations . . . 10,250.028,
10,250.051

LOAN LOSS ALLOWANCES

- Illustrations of Computations . . . 10,060.53—54
- Real Estate Investment Trusts . . . 10,060.13—23; 10,060.27—28; 10,060.29A—29C; 10,060.35; 10,060.53—54; 10,170.02; 10,170.06

LOANS RECEIVABLE

- Colleges and Universities . . . 10,020.10—12
- Interest Revenue Recognition
 - Discontinued . . . 10,060.30—38
- Net Realizable Value . . . 10,060.17—18; 10,060.20—27; 10,060.29B—29C; 10,060.53—54; 10,170.02; 10,170.06
- Real Estate Ventures . . . 10,240.15—20; 10,240.33—35
- REIT Loans . . . 10,060.04; 10,170.01—06

LONG-TERM DEBT—See Liabilities**LOSS RECOGNITION**

- Completed-Contract Method . . . 10,330.85—89
- Construction-Type Contracts . . . 10,330.24—25; 10,330.37; 10,330.85—89
- Cost-Type Contracts . . . 10,330.86
- Marketable Equity Securities . . . 10,160.06
- Percentage of Completion Method . . . 10,330.24—25; 10,330.33; 10,330.85—89
- Production-Type Contracts . . . 10,330.24—25; 10,330.37; 10,330.85—89
- Real Estate Ventures . . . 10,240.14—20; 10,240.31

LOSSES

- Bank's Investment Securities . . . 10,360.01—18
- Contracts . . . 10,330.24—25; 10,330.37; 10,330.88
- Intercompany Transactions . . . 10,240.07
- Investments, Nonprofit Organizations . . . 10,250.028; 10,250.051; 10,250.072—083; 10,250.116—117
- Loans of REITs . . . 10,060.08—29C; 10,170.02—06
- Marketable Securities Investments . . . 10,160.02; 10,160.06; 10,160.09—14
- Medical Malpractice Claims . . . 10,410.01; 10,410.10—27; 10,410.52—53; 10,410.65; 10,410.74
- Money-Market Funds . . . 10,140.18—20
- Options . . . 10,140.30—31
- Real Estate Ventures . . . 10,240.14—20; 10,240.31; 10,240.39—40
- Recognition—See Loss Recognition
- Recoverability of REIT Loans . . . 10,060.15—18; 10,060.30—38; 10,060.53—54
- Unrealized—See Unrealized Depreciation

LOWER OF COST OR MARKET

- Accounting for Inventories of Crops . . . 10,390.028—030; 10,390.038—039
- Agricultural Cooperatives
 - Inventories . . . 10,390.069; 10,390.083
- Marketable Debt Securities . . . 10,250.079—080
- Marketable Equity Securities . . . 10,160.03—07; 10,160.12—17; 10,250.079—080
- Mortgage-Backed Securities . . . 10,400.29

MANAGEMENT

- Control . . . 10,250.042
- Estimates on Contracts . . . 10,330.26—29; 10,330.44
- Hospital-Related Organizations . . . 10,340.09
- Limited Partnerships . . . 10,240.01; 10,240.08—10
- Municipal Bond Funds . . . 10,260.14
- Nonprofit Organizations . . . 10,250.010; 10,250.030; 10,250.086—087; 10,250.091; 10,250.120
- Real Estate Projects . . . 10,240.01

MANAGEMENT—continued

- Restricted Funds . . . 10,250.058—060
- Total Return Approach . . . 10,250.075—076

MARKET VALUE

- Allocation for Pooled Investments . . . 10,160.08
- Investments, Nonprofit Organizations . . . 10,250.077—081; 10,250.116—117
- Investments, Short-Term . . . 10,140.46
- Marketable Equity Securities . . . 10,160.03—07; 10,160.12—17
- Mortgage-Backed Securities . . . 10,400.29
- Municipal Bonds . . . 10,260.12—16
- Options . . . 10,140.28
- Recovery After Write-Down . . . 10,160.14
- Regulated Investment Companies . . . 10,240.03
- REIT Adviser's Operating Support . . . 10,060.51

MARKETABLE SECURITIES**INVESTMENTS**

- Carrying Amount . . . 10,160.03—08; 10,160.12—14; 10,250.025; 10,250.077—083
- Decline in Market Price . . . 10,160.06; 10,160.14—15
- Hospitals . . . 10,160.01—17
- Municipal Bonds—See Municipal Bonds
- Personal Financial Statements . . . 10,350.17—19
- Real Estate Ventures . . . 10,240.30
- Terminology . . . 10,160.03
- Valuation Allowances—See Allowances, Valuation
- "When Issued" Securities . . . 10,260.19—20

MARKETING

- Contract Sales . . . 10,330.14

MATCHING PRINCIPLE

- Completed-Contract Method . . . 10,330.30—31; 10,330.72
- Percentage of Completion Method . . . 10,330.22; 10,330.31; 10,330.80

MATERIALITY

- Completed-Contract Method . . . 10,330.31
- Estimate Changes . . . 10,330.84
- Hospital-Related Organizations . . . 10,340.11—12
- Nonprofit Organizations . . . 10,250.003; 10,250.038; 10,250.071
- Pricing Errors . . . 10,260.14
- Real Estate Ventures . . . 10,240.41
- REIT Adviser's Operating Support . . . 10,060.52
- Valuation of Municipal Bonds . . . 10,260.17
- Variances From GAAP . . . 10,240.24

MATERIALS

- Contract Costs . . . 10,330.69; 10,330.72
- Customer Furnished . . . 10,330.60
- Donated . . . 10,250.071
- Input Measure on Contracts . . . 10,330.48—50
- Precontract Costs . . . 10,330.73—75

MATRIX PRICING

- Municipal Bonds . . . 10,260.16—18

MEASUREMENT

- Assets Affected by Debt Restructuring . . . 10,170.03—06
- Bases Used in Accounting . . . 10,170.03
- Contract Costs . . . 10,330.68—78
- Contract Revenue . . . 10,330.17; 10,330.53—67
- Depreciation . . . 10,250.106
- Facilities Donated . . . 10,250.071
- Materials Donated . . . 10,250.071
- Personal Financial Statements . . . 10,350.02
- Production-Type Contracts . . . 10,330.02

MEASUREMENT—continued

Progress on Contracts	10,330.43— 52, 10,330.79— 84
Services Donated	10,250.067— 069
Total Return Approach	10,250.076

MEDICAID

Hospital Costs	10,340.03
----------------	-----------

MEDICAL MALPRACTICE CLAIMS

Actuarial Estimates	10,410.11, 10,410.16, 10,410.19— 20
Captive Insurance Companies	10,410.16, 10,410.19; 10,410.54— 65
Claims-Made Policies	10,410.33— 43
Contingencies	10,410.29
Costs	10,410.17, 10,410.21
Disclosure	10,410.12, 10,410.18, 10,410.22, 10,410.29— 32, 10,410.52— 53, 10,410.64— 65, 10,410.75
Discounting Accrued Unpaid	
Claims	10,410.30— 32
Estimation of Losses	10,410.11, 10,410.22— 27
Financial Statements	10,410.21— 29, 10,410.62
Industry Experience in Estimation of	
Losses	10,410.27— 28
Losses	10,410.01, 10,410.10— 27, 10,410.52— 53, 10,410.65, 10,410.74
Relevant Accounting	
Pronouncements	10,410.07
Retrospectively Rated Premiums	10,410.44— 53, 10,410.63— 64
Risk Management Systems	10,410.09, 10,410.13— 14, 10,410.67
Tail Coverage	10,410.33— 43
Terminology	10,410.05, 10,410.10
Trust Funds	10,410.16, 10,410.19, 10,410.66— 75
Types of Loss Contingencies	10,410.10
Uninsured Asserted and Unasserted	
Claims	10,410.08— 29

MEDICARE

Hospital Costs	10,340.03
----------------	-----------

MEMBERSHIP FEES

Nonprofit Organizations	10,250.084, 10,250.096
-------------------------	---------------------------

MINORITY INTERESTS

Personal Financial Statements	10,350.19
Real Estate Ventures	10,240.05

MISLEADING FINANCIAL STATEMENTS

Nonprofit Organizations	10,250.037— 040
-------------------------	-----------------

MONEY-MARKET FUNDS

Amendment to Investment Company	
Guide	10,140.02, 10,140.04— 20
Definition	10,140.04
Distribution Policies	10,140.06— 08
Income Per Share	10,140.14
Income Taxes	10,140.20
Organization Costs	10,140.39— 41
Reporting Gains and Losses	10,140.18— 19
Statement of Changes in Net	
Assets	10,140.09— 13
Supplementary Information	10,140.14— 17

MORTGAGE BANKS

Mortgage-Backed Securities	10,400.29
Repurchase—Reverse Repurchase	
Agreements	10,380.14

MORTGAGE DEBT

Primary Mortgage Market	10,380.01
Secondary Mortgage Market	10,380.01— 04, 10,400.07— 10

MORTGAGE LOANS RECEIVABLE

Interest Revenue Recognition	
Discontinued	10,060.30— 38

MORTGAGE LOANS RECEIVABLE—

continued	
Loan Loss Allowances	10,060.29A— 29C, 10,060.53— 54, 10,170.02, 10,170.06
Mortgage-Backed Securities	10,400.28
Troubled Debt Restructuring	10,170.01— 06
Types of REIT Loans	10,060.04

MUNICIPAL BOND FUNDS

Background Information	10,260.01— 03
Disclosure Requirements	10,260.20, 10,260.25— 28
Distribution Policies	10,260.37— 38
Distribution Requirements	10,260.35— 36
Equalization Accounting	10,260.33— 34
Expenses	10,260.34, 10,260.39
Illustration	10,260.34
Portfolio Insurance	10,260.21— 25
Pricing Services	10,260.13— 15
Rules for Qualification	10,260.29
Tax Status	10,260.29— 32
Transition	10,260.40
Valuation of Municipal Bonds	10,260.10— 28
"When Issued" Securities	10,260.19— 20

MUNICIPAL BONDS

Classification	10,260.05— 06, 10,260.26
Credit Rating	10,260.22, 10,260.27
Default	10,260.21— 25
Discounts	10,260.30— 31
General Obligation	10,260.06
Industrial Development	10,260.05— 06
Market	10,260.09
Premiums	10,260.30— 32
Prices	10,260.09
Purpose	10,260.04— 05
Valuation	10,260.10— 28
Yield	10,260.07, 10,260.18

MUNICIPAL NOTES

Description	10,260.08
-------------	-----------

MUSEUMS

Financial Statements	10,250.133
----------------------	------------

MUTUAL FUNDS—See Investment Companies

MUTUAL INSURANCE COMPANIES

Nonprofit Organizations	10,250.005
-------------------------	------------

MUTUAL SAVINGS BANKS

Nonprofit Organizations	10,250.005
-------------------------	------------

NACUBO—See National Association of College and University Business Officers

NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS

Classification of Revenues &	
Expenditures	10,020.01— 12

NATIONAL CENTER FOR HIGHER EDUCATION MANAGEMENT SYSTEMS

Classification of Revenues and	
Expenditures	10,020.01— 06

NCHEMS—See National Center for Higher Education Management Systems

NET ASSET VALUE

Distribution Policies	10,140.06— 07
Municipal Bond Funds	10,260.31

NET INCOME

Banks	10,360.16
Investment Securities Gains or	
Losses	10,360.16

NET REALIZABLE VALUE

Agricultural Cooperatives	
Inventories	10,390.069—071, 10,390.076—077, 10,390.084—085
Contract Costs	10,330.72
Investments in Agricultural Cooperatives	10,390.089
Pledges	10,250.064—066
Real Estate Projects	10,350.24
REIT Loans	10,060.17—18, 10,060.20—27, 10,060.29B—29C, 10,060.53—54, 10,170.02, 10,170.06

NONEXPENDABLE ADDITIONS—See Capital Additions**NONOPERATING REVENUE**

Marketable Equity Securities	10,160.06—07, 10,160.09—12
--	----------------------------

NONPROFIT ORGANIZATIONS

Accounting Principles	10,250.001—141
Accrual Basis Accounting	10,250.011—013
Allocation of Costs	10,250.127
Audit Guides (AICPA)	10,250.001—002
Auxiliary Activities	10,250.069, 10,250.126
Balance Sheets	10,250.016—017, 10,250.019—024, 10,250.105—123
Capital Additions	10,250.050—053
Carrying Amount of Investments	10,250.077—083
Cash Basis Accounting	10,250.011—013
Collections	10,250.113—115
Comparative Financial Statements	10,250.041, 10,250.128
Contracts	10,330.14
Expenses	10,250.085—104
Facilities Donated	10,250.071
Financial Statements	10,250.008—011, 10,250.016—041
Financial Statements Illustrated	10,250.128—141
Fixed Assets	10,250.105—112
Format of Financial Statements	10,250.036—041
Fund Accounting	10,250.014—015
Grants	10,250.101—102
Health Care Entities	10,370.01—25
Hospital-Related Organizations	10,340.01—16
Hospitals	10,160.01, 10,160.04—05, 10,340.01—16
Interfund Borrowings	10,250.118—119
Interrelated Organizations	10,250.042—048
Investment Income	10,250.072—076
Investment Pools	10,250.116—117
Materials Donated	10,250.071
Membership Fees	10,250.084
Objectives of Financial Reporting	10,250.009
Pledges	10,250.064—066
Reporting Practices	10,250.001—141
Services Donated	10,250.067—070
Special Reports	10,250.002, 10,250.007, 10,250.013
Statements of Activity	10,250.016—017, 10,250.025—031, 10,250.050
Statements of Changes in Financial Position	10,250.016—017
Subscription Income	10,250.084
Support—See Support	
Taxes	10,250.103
Terminology	10,250.126
Total Return Approach	10,250.075—076, 10,250.104
Totals of All Funds	10,250.037—040
Transfers Between Funds	10,250.104
Transition	10,250.124—125
Types of Organizations Covered	10,250.005—006

NONPROFIT ORGANIZATIONS—continued

Users of Financial Statements	10,250.008—010
---	----------------

NOTES TO FINANCIAL STATEMENTS

Accounting Policies	10,330.21
Allocation of Costs	10,250.100
Botanical Societies	10,240.141
Broadcasting Stations	10,250.136
Cemetery Organizations	10,250.130
Claims by Contractors	10,330.65—66
Clubs	10,250.131
Colleges and Universities	10,020.11
Combined Financial Statements	10,250.044
Commitments	10,250.012
Completed-Contract Method	10,330.52
Contributions to ESOPs	10,130.10
Donated Services	10,250.070
Effects of Debt Restructuring	10,060.29C, 10,170.06
Foundations	10,250.135
Fund-Raising Activities	10,250.094
Grants	10,250.102
Hospital-Related Organizations	10,340.10—12
Interest Rate for REIT Loans	10,060.23
Libraries	10,250.132
Marketable Equity Securities	10,160.12
Medical Malpractice Claims	10,410.12, 10,410.18, 10,410.29, 10,410.32, 10,410.52—53, 10,410.65
Mortgage-Backed Securities	10,400.31
Museums	10,250.133
Nonprofit Organizations	10,250.016, 10,250.038—044, 10,250.083—085, 10,250.128—141
Pass-Through Securities	10,400.31
Percentage of Completion Method	10,330.45
Performing Arts Organizations	10,250.134
Personal Financial Statements	10,350.31, 10,350.34
Religious Organizations	10,250.137
Repurchase—Reverse Repurchase Agreements	10,400.31, 10,400.34
Research Organizations	10,250.138
Restrictions on Fund Balances	10,250.021
Schools	10,250.129
Scientific Organizations	10,250.138
Trade Associations	10,250.139
Unions	10,250.140
Zoological Societies	10,250.141

OBJECTIVES OF FINANCIAL REPORTING

Nonprofit Organizations	10,250.009
-----------------------------------	------------

OFFICERS—See Employees**OPEN END INVESTMENT COMPANIES**

Money-Market Funds	10,140.04—20
Registration Fees	10,140.40

OPERATING CYCLES

Nonprofit Organizations	10,250.023
-----------------------------------	------------

OPINIONS, AUDITORS'

Bank's Investment Securities Gains or Losses	10,360.16
Cash Basis Statements	10,250.013
Consistency	10,360.16
Municipal Bond Funds	10,250.17

OPTIONS

Contracts	10,330.54, 10,330.64
Personal Financial Statements	10,350.20
Put and Call—See Put and Call Options	

OPTIONS CLEARING CORPORATION

Exercise of Options	10,140.26
-------------------------------	-----------

ORGANIZATION COSTS

- Investment Companies 10,140.39—44

OVER-THE-COUNTER SECURITIES

- Personal Financial Statements 10,350.18
- Valuation 10,260.10—11; 10,350.18

PAID-IN CAPITAL

- Registration Fees 10,140.41

PARTNERS

- Liability 10,240.01, 10,240.06; 10,240.15
- Limited 10,240.08—10
- Rights 10,240.09
- Timing Differences 10,240.06, 10,240.08

PARTNERSHIPS

- Capital Contributions 10,240.32
- Conditions for Control 10,240.07—11
- Definition 10,240.01
- Equity Method 10,240.06—11
- General 10,240.01, 10,240.06—07
- Limited—See Limited Partnerships
- Municipal Bond Funds 10,260.03

PAYABLES

- Back Charges on Contracts 10,330.77
- Colleges and Universities 10,020.10
- Defined as Liabilities 10,020.10
- Personal Financial Statements 10,350.27—29
- Reduction in Debt Restructuring 10,060.29C, 10,170.06

PENSION PLANS

- Nonprofit Organizations 10,250.005
- Personal Financial Statements 10,350.26, 10,350.31

PERCENTAGE OF COMPLETION METHOD

- Accounting Changes 10,330.25, 10,330.82—84, 10,330.90—91
- Accounting Policies 10,330.22—25, 10,330.32—33
- Alternative Accounting Principles 10,330.80—81
- Applicability of Method 10,330.04—05
- Billings on Contracts 10,330.22
- Change Orders 10,330.62—63, 10,330.87
- Consistency 10,330.45; 10,330.68, 10,330.78—81
- Costs 10,330.68—84
- Definition 10,330.04
- Disclosure Requirements 10,330.45, 10,330.82—84, 10,330.90—91
- Estimation 10,330.23—29, 10,330.43—51, 10,330.68—84
- Events 10,330.53
- Financial Position 10,330.31
- Financial Statements 10,330.22, 10,330.90—91
- Government Contracts 10,330.19
- Income Statements 10,330.33, 10,330.80—81
- Loss Recognition 10,330.24—25, 10,330.33, 10,330.85—89
- Matching Principle 10,330.22, 10,330.31, 10,330.80
- Results of Operations 10,330.31
- Revenue Recognition 10,330.43—51, 10,330.53—67, 10,330.71, 10,330.79—81
- Rights of Contracting Parties 10,330.22—23
- Statements of Financial Position 10,330.80
- Subsequent Events 10,330.82
- Uncertainties 10,330.26—29, 10,330.53—55
- Use of Method 10,330.22—29

PERFORMANCE ON CONTRACTS

- Back Charges 10,330.76—77
- Change Orders 10,330.61—63

PERFORMANCE ON CONTRACTS—

- continued
- Completed-Contract Method 10,330.30—31; 10,330.52
- Costs to Complete 10,330.78
- Customer-Furnished Materials 10,330.60
- Loss Recognition 10,330.24—25; 10,330.37, 10,330.85—89
- Percentage of Completion Method 10,330.22—23; 10,330.33; 10,330.43—51, 10,330.55—57
- Profit Centers 10,330.17; 10,330.34—42
- Specifications by Customers 10,330.01, 10,330.12

PERFORMING ARTS ORGANIZATIONS

- Financial Statements 10,250.134

PERMANENT DIFFERENCES

- Real Estate Ventures 10,240.06—08

PERSONAL FINANCIAL STATEMENTS

- Alimony 10,350.26; 10,350.28
- Annuities 10,350.26
- Applicability of FASB Statements 10,350.32
- Appraisals 10,350.13, 10,350.23—24
- Assets 10,350.03—04; 10,350.06—26; 10,350.31
- Basis of Presentation 10,350.03—04
- Business Investments 10,350.10—11, 10,350.14, 10,350.19; 10,350.22—23, 10,350.31
- Cash Basis Accounting 10,350.07, 10,350.31
- Charitable Pledges 10,350.28
- Classification of Accounts 10,350.08
- Commitments 10,350.28
- Comparative—See Comparative Financial Statements
- Compensation Contracts 10,350.26
- Contingencies 10,350.32
- Disclosures 10,350.21, 10,350.31
- Effective Date 10,350.33
- Estimated Current Amount of Liabilities—See Estimated Current Amount of Liabilities
- Estimated Current Value of Assets—See Estimated Current Value of Assets
- Expenses 10,350.06
- Generally Accepted Accounting Principles 10,350.02, 10,350.31—32
- Generally Accepted Auditing Standards 10,350.02
- Historical Costs 10,350.02—04, 10,350.13
- Illustrations 10,350.34—35
- Income Taxes 10,350.01, 10,350.03, 10,350.06, 10,350.29—31, 10,350.35
- Insurance 10,350.21, 10,350.31
- Intangible Assets 10,350.25, 10,350.31
- Interest 10,350.27, 10,350.31
- Investments 10,350.10—11, 10,350.14, 10,350.17—19, 10,350.21—24, 10,350.31
- Joint Ownership Arrangements 10,350.09, 10,350.31
- Judgment 10,350.12, 10,350.22
- Leaseholds 10,350.24
- Legal Matters 10,350.09, 10,350.30
- Liabilities 10,350.03—04, 10,350.06—08, 10,350.11—13, 10,350.15, 10,350.27—31
- Life Insurance 10,350.21, 10,350.31
- Marketable Securities 10,350.17—19
- Methods of Presentation 10,350.07—11
- Net Worth 10,350.06, 10,350.30
- Nonforfeitable Rights 10,350.26, 10,350.31
- Notes to Financial Statements 10,350.31, 10,350.34
- Options 10,350.20
- Payables 10,350.27—29
- Pension Plans 10,350.26, 10,350.31

PERSONAL FINANCIAL STATEMENTS—

- continued
- Provision for Estimated Income
 - Taxes . . . 10,350.06, 10,350.30—31, 10,350.35
- Purpose . . . 10,350.01—04
- Real Estate Investments . . . 10,350.11, 10,350.14; 10,350.24
- Receivables . . . 10,350.16, 10,350.31
- Related Parties . . . 10,350.01, 10,350.32
- Reporting Entity . . . 10,350.05
- Restatements . . . 10,350.33
- Rights . . . 10,350.26, 10,350.31
- Securities . . . 10,350.14, 10,350.17—19, 10,350.31
- Statements of Changes—See Statements of Changes in Net Worth
- Statements of Financial Condition—See Statements of Financial Condition
- Supplementary Information . . . 10,350.04
- Trusts . . . 10,350.26
- Useful Life of Assets . . . 10,350.31

PERSONNEL COSTS

- Allocation of Costs . . . 10,250.127
- Employee Stock Ownership Plans . . . 10,130.09—10; 10,130.12—13
- Nonprofit Organizations . . . 10,250.091—092, 10,250.098—099

PLANT FUNDS

- Educational Institution . . . 10,020.11—12
- Hospitals . . . 10,160.11
- Interfund Borrowings . . . 10,250.118—119
- Investment Income . . . 10,250.073
- Nonprofit Organizations . . . 10,250.020—022, 10,250.026—028
- Restricted Funds . . . 10,250.051—052

PLEDGES RECEIVABLE

- Definition . . . 10,250.126
- Nonprofit Organizations . . . 10,250.064—066, 10,250.095

PORTFOLIO, MARKETABLE SECURITIES

- Investor-Owned Hospitals . . . 10,160.01—03
- Municipal Bonds . . . 10,260.10—28
- Not-For-Profit Hospitals . . . 10,160.04—05

PREMIUM ON DEBT

- Municipal Bonds . . . 10,260.30—32, 10,260.39

PREPAID EXPENSES

- Colleges and Universities . . . 10,020.10

PRESENT VALUE

- Annuity Gifts . . . 10,250.121
- REIT Loans . . . 10,060.23, 10,060.53—55

PRICES

- Change Orders . . . 10,330.61—63
- Contract Options . . . 10,330.64
- Costs to Complete . . . 10,330.78
- Future—See Future Price
- Marketable Securities . . . 10,350.17—19
- Matrix Pricing . . . 10,260.18
- Municipal Bonds . . . 10,260.09—20
- Options . . . 10,350.20
- Selling—See Selling Price
- Types of Contracts . . . 10,330.15, 10,330.54—59, 10,330.93

PRIOR PERIOD ADJUSTMENTS

- Nonprofit Organizations . . . 10,250.125

PROBABILITY

- Claims by Contractors . . . 10,330.65
- Cost Recovery on Contracts . . . 10,330.62, 10,330.75
- Default on Municipal Bonds . . . 10,260.21—23
- Estimation on Contracts . . . 10,330.25, 10,330.55
- Losses on Real Estate Ventures . . . 10,240.18

PRODUCTION-TYPE CONTRACTS

- Accounting Policies . . . 10,330.02; 10,330.21

PRODUCTION-TYPE CONTRACTS—

- continued
- Allocation of Costs . . . 10,330.69—72, 10,330.87
- Combining Contracts . . . 10,330.34—38
- Computer Software . . . 10,330.01
- Costs of Component Parts . . . 10,330.50
- Effective Date . . . 10,330.91
- Estimation . . . 10,330.02—05
- Expenses . . . 10,330.02
- Generally Accepted Accounting Principles . . . 10,330.01, 10,330.10—11, 10,330.72
- Illustrative Chart . . . 10,330.92
- Loss Recognition . . . 10,330.24—25, 10,330.37, 10,330.85—89
- Percentage of Completion—See Percentage of Completion Method
- Precontract Costs . . . 10,330.73—75
- Profit Centers . . . 10,330.34—42
- Segmenting Contracts . . . 10,330.34, 10,330.39—42, 10,330.85
- Specifications by Customers . . . 10,330.01, 10,330.11
- Time Periods . . . 10,330.02
- Transition . . . 10,330.90—91

PROFIT CENTERS

- Accounting Policies . . . 10,330.21
- Combining Contracts . . . 10,330.34—38
- Construction-Type Contracts . . . 10,330.34—42
- Definition . . . 10,330.17
- Determination . . . 10,330.34—42
- Percentage of Completion Method . . . 10,330.25
- Production-Type Contracts . . . 10,330.34—42
- Segmenting Contracts . . . 10,330.34, 10,330.39—42

PROPERTY

- Construction—See Construction in Progress
- Donated . . . 10,250.071
- Net Realizable Value . . . 10,060.17—18; 10,060.20—27; 10,060.298—29C, 10,060.53—54; 10,170.02, 10,170.06
- Real Estate—See Real Estate
- Titles—See Property Titles
- Undivided Interests . . . 10,240.01, 10,240.11, 10,240.18—19

PROPERTY TITLES

- Accrual Basis Accounting . . . 10,250.012
- Undivided Interests . . . 10,240.01

PROSPECTUSES

- Cost of Printing . . . 10,140.44
- Municipal Bond Funds . . . 10,260.12

PURCHASE LEASEBACK

- Definition . . . 10,060.04

PURCHASES

- Real Estate Ventures . . . 10,240.36—38

PUT AND CALL OPTIONS

- Accounting Procedures . . . 10,140.28—33
- Amendment to Investment Company Guide . . . 10,140.02, 10,140.21—37
- Glossary of Terms . . . 10,140.22
- Income Taxes . . . 10,140.34—37
- Option Writing . . . 10,140.23—27

RANCHERS—See Agricultural Producers**REAL ESTATE**

- Depreciation . . . 10,240.30
- Foreclosed Property . . . 10,060.53—54
- Forms of Ownership . . . 10,240.01
- Investment Trusts—See Real Estate Investment Trusts
- Investments, Nonprofit Organizations . . . 10,250.079

REAL ESTATE—continued

- Mortgage Loans—See Mortgage Loans
- Receivable
- Personal Financial Statements 10,350.11,
10,350.14, 10,350.24
- Sales—See Real Estate Sales
- Ventures—See Real Estate Ventures

REAL ESTATE INVESTMENT TRUSTS

- Adviser's Operating Support . . . 10,060.47—52
- Commitment Fees 10,060.39—46
- Commitments 10,060.05
- Cost of Capital 10,060.21, 10,060.53—54
- Disclosure Requirements 10,060.23,
10,060.27, 10,060.29C, 10,060.48; 10,060.52;
10,170.06
- Factors in Financial Success 10,060.06
- Foreclosures 10,060.10—13, 10,060.17,
10,060.26—28, 10,060.35; 10,060.53—54,
10,170.01—06
- Illustration of Construction Loan . . . 10,060.53
- Illustration of Residential Loan . . . 10,060.54
- Income Taxes 10,060.02
- Interest Rate 10,060.20—24, 10,060.53—54
- Interest Revenue Recognition
 - Discontinued 10,060.30—38
- Recoverability of Loan Losses . . . 10,060.15—
18, 10,060.30—38; 10,060.53—54
- Risks 10,060.08
- Scope of Activities 10,060.04—06
- SOP No. 75-2 Amended 10,170.01—06
- Terminology 10,060.04
- Troubled Debt Restructuring . . . 10,060.13,
10,170.01—06

REAL ESTATE SALES

- Real Estate Ventures 10,240.36
- Revenue Recognition 10,240.22—23,
10,240.30

REAL ESTATE VENTURES

- Accounting Policies 10,240.02
- Allocation of Investor Income . . . 10,240.25
- Assets 10,240.09; 10,240.14, 10,240.20;
10,240.25—28
- Business Combinations 10,240.27
- Capital Contributions 10,240.29—32
- Commitments 10,240.15—20
- Contingencies 10,240.19
- Corporate Joint Ventures 10,240.04—05
- Depreciation 10,240.25; 10,240.27—28
- Disclosure 10,240.06, 10,240.12—13, 10,240.41
- Equity in Net Assets 10,240.26—28
- Equity Method 10,240.04—28
- Examples 10,240.25; 10,240.30
- Expenses 10,240.25, 10,240.28
- Financing 10,240.07, 10,240.11, 10,240.20
- Form v Substance 10,240.02, 10,240.07—10;
10,240.25, 10,240.37
- Forms of Ownership 10,240.01—02
- Gains or Losses 10,240.39—40
- General Partnerships 10,240.01, 10,240.06—
07
- Impairment of Value 10,240.14, 10,240.20
- Income from Loans or Advances . . . 10,240.33—35
- Income Statements 10,240.06
- Income Taxes 10,240.06—08, 10,240.24,
10,240.40
- Intangible Assets 10,240.27, 10,240.32
- Legal Requirements 10,240.02, 10,240.15—
18
- Limited Partnerships 10,240.01, 10,240.08—
10
- Liquidation 10,240.25
- Loan Agreements 10,240.33—35
- Losses 10,240.14—20; 10,240.31, 10,240.39—40
- Marketable Securities 10,240.30
- Minority Interests 10,240.05
- Permanent Differences 10,240.06—08

REAL ESTATE VENTURES—continued

- Purchases of Real Estate 10,240.36
- Purchases of Services 10,240.37
- Restatements 10,240.41
- Revenue 10,240.06; 10,240.25; 10,240.28
- Sale of an Interest 10,240.39—40
- Sales to Investors 10,240.38
- Statements of Changes in Financial
 - Position 10,240.13
- Statements of Financial Position . . . 10,240.06
- Subsidiaries 10,240.05—07, 10,240.10;
10,240.28
- Timing Differences 10,240.06—08; 10,240.40
- Transition 10,240.41
- Undivided Interests 10,240.11; 10,240.18—19

REALIZABLE VALUE—See Net Realizable Value

REALIZATION

- Current v. Noncurrent Assets 10,250.023
- Definition 10,330.03
- Earnings Process 10,240.22; 10,240.30
- Intercompany Transactions 10,240.21—23
- Investment Gains and Losses 10,140.36—
37; 10,260.29; 10,260.37
- Marketable Equity Securities 10,160.09—
13
- Principle of Realization 10,330.03; 10,330.14
- REIT Loans 10,060.30—38

RECEIVABLES

- Back Charges on Contracts 10,330.77
- Classified as Assets 10,020.10
- Collection—See Collection of Receivables
- Colleges and Universities 10,020.10—12
- Loans—See Loans Receivable
- Mortgages—See Mortgage Loans Receivable
- Personal Financial Statements . . . 10,350.16,
10,350.31
- Real Estate Ventures 10,240.13; 10,240.34
- Unbilled—See Unbilled Receivables

RECOVERABILITY—See Return on Investment

REDEMPTION OR CALL

- Amortization of Premium 10,260.32
- Municipal Bond Funds 10,260.38

REGISTRATION FEES

- Investment Companies 10,140.40—41,
10,140.44

REGULATED INVESTMENT COMPANIES

- Accounting for Investments 10,240.03
- Municipal Bond Funds 10,260.29—39
- Rules for Qualification 10,140.36—37,
10,260.29

REGULATIONS

- Cost-Type Governmental
 - Contracts 10,330.57
 - Defense Acquisition Regulation . . . 10,330.08
 - Federal Procurement Regulation 10,330.08

REGULATORY AUTHORITIES

- CASB—See Cost Accounting Standards Board
- Hospitals 10,340.02—03
- Specifications by Customers 10,330.12

REIT—See Real Estate Investment Trusts

RELATED PARTY TRANSACTIONS

- Hospital-Related Organizations . . . 10,340.09—12
- Nonprofit Organizations 10,250.049
- Personal Financial Statements . . . 10,350.32
- REIT Adviser's Operating Support . . . 10,060.47—52

RELIABILITY

- Contract Estimates . . . 10,330.26—29, 10,330.65

RELIGIOUS ORGANIZATIONS

- Donated Services . . . 10,250.067
- Financial Statements . . . 10,250.048, 10,250.137
- Fixed Assets . . . 10,250.108

RENTAL EXPENSE

- Nonprofit Organizations . . . 10,250.092, 10,250.098

RENTAL REVENUE

- Investments, Nonprofit Organizations . . . 10,250.074

REPLACEMENT COST

- Fixed Assets . . . 10,250.105, 10,250.111

REPURCHASE—REVERSE REPURCHASE**AGREEMENTS**

- Banks . . . 10,380.06, 10,380.14, 10,400.12
- Broker/Dealers in Securities . . . 10,380.06, 10,380.14, 10,400.13
- Business Risk . . . 10,400.19
- Collateral Loss . . . 10,400.22—25
- Credit Risk . . . 10,400.21—23
- Credit Unions . . . 10,400.14
- Definition . . . 10,380.05—06
- Disclosure . . . 10,400.03, 10,400.11—17, 10,400.25—27, 10,400.31
- Dollar Agreements—See Dollar Repurchase—Dollar Reverse
- Repurchase Agreements
- Illustrative Financial Statement Notes . . . 10,400.34
- Legal Considerations . . . 10,400.24
- Market Risk . . . 10,400.20, 10,400.22
- Mortgage Banks . . . 10,380.14
- Mortgage-Backed Securities . . . 10,400.28
- Risks . . . 10,400.18—25
- Savings and Loan Associations . . . 10,380.06, 10,380.13—14, 10,400.01—34
- Uses . . . 10,400.06
- vs Dollar Repurchase—Dollar Reverse
- Repurchase Agreements . . . 10,380.15—17, 10,400.05

RESEARCH AND DEVELOPMENT COSTS

- Expenses . . . 10,330.74

RESEARCH ORGANIZATIONS

- Financial Statements . . . 10,250.138

RESERVES

- Stabilization . . . 10,020.10

RESIDENTIAL LOANS

- Illustration of REIT Accounting . . . 10,060.54

RESTATEMENTS

- Accounting Changes for Contracts . . . 10,330.90
- Hospital-Related Organizations . . . 10,340.13
- Nonprofit Organizations . . . 10,250.125
- Personal Financial Statements . . . 10,350.33
- Real Estate Ventures . . . 10,240.41

RESTRICTED FUNDS

- Capital Additions . . . 10,250.051—053
- Colleges and Universities . . . 10,020.10—12
- Combined Financial Statements . . . 10,250.045
- Definition . . . 10,250.126
- Health Care Entities . . . 10,370.07—10, 10,370.18—19, 10,370.23
- Hospitals . . . 10,160.05, 10,160.08
- Interfund Borrowings . . . 10,250.118—119
- Investment Income . . . 10,250.072—076
- Investments . . . 10,250.080—082
- Nonprofit Organizations . . . 10,250.014—015, 10,250.021—024, 10,250.028—029, 10,250.045, 10,250.054—062
- Totals of All Funds . . . 10,250.037—040

RESTRUCTURING OF DEBT

- Definition . . . 10,170.03
- Equity Interest Granted . . . 10,170.03
- REIT Loans . . . 10,060.10—13, 10,060.35, 10,170.01—06

RESULTS OF OPERATIONS

- Completed-Contract Method . . . 10,330.31
- Nonprofit Organizations . . . 10,250.017, 10,250.078
- Percentage of Completion Method . . . 10,330.31

RETROACTIVITY

- Accounting Changes for Contracts . . . 10,330.90
- Hospital-Related Organizations . . . 10,340.13
- Nonprofit Organizations . . . 10,250.105, 10,250.112, 10,250.125
- Real Estate Ventures . . . 10,240.41

RETURN ON INVESTMENT

- Money-Market Funds . . . 10,140.15—17
- Municipal Bonds . . . 10,260.07, 10,260.18
- Nonprofit Organizations . . . 10,250.072—076
- Total Return Approach . . . 10,250.075—076

REVENUE

- Classification by Source . . . 10,020.02
- Commitment Fees . . . 10,060.39—46
- Current Funds . . . 10,020.10
- Definition . . . 10,250.126
- Estimation . . . 10,330.04, 10,330.23—29, 10,330.53—67
- Interest—See Interest Income
- Investments—See Investment Income
- Nonoperating—See Nonoperating Revenue
- Nonprofit Organizations . . . 10,250.025—031, 10,250.050, 10,250.071
- Real Estate Ventures . . . 10,240.06, 10,240.25, 10,240.28
- Recognition—See Revenue Recognition
- Reimbursable Costs . . . 10,330.57—60
- REIT Adviser's Operating Support . . . 10,060.47—52
- Rental—See Rental Revenue
- Subscriptions—See Subscription Income
- Tax-Exempt—See Tax-Exempt Revenue

REVENUE ACT OF 1978

- Regulated Investment Companies . . . 10,260.29

REVENUE BONDS

- Definition . . . 10,370.07
- Health Care Entities . . . 10,370.02—03
- Municipal Bonds . . . 10,260.06

REVENUE RECOGNITION

- Claims by Contractors . . . 10,330.65—66
- Combining Contracts . . . 10,330.34—38
- Commitment Fees . . . 10,060.39—46
- Completed-Contract Method . . . 10,330.30—31, 10,330.71
- Construction-Type Contracts . . . 10,330.02
- Hospitals . . . 10,160.09—11
- Interest Revenue Discontinued . . . 10,060.30—38
- Nonprofit Organizations . . . 10,250.055—063, 10,250.084
- Percentage of Completion Method . . . 10,330.43—51, 10,330.53—67, 10,330.71, 10,330.79—81
- Production-Type Contracts . . . 10,330.02
- Profit Centers—See Profit Centers
- Purchases From Real Estate Ventures . . . 10,240.38

REVENUE RECOGNITION—continued

Real Estate Loans	10,240 34
Real Estate Sales	10,240 22— 23, 10,240 30
Realization Principle	10,330 03, 10,330 14
REIT Adviser's Operating Support	10,060 51— 52
Segmenting Contracts	10,330 34,
	10,330 39— 42
Services to Real Estate Ventures	10,240 37
Units-of-Delivery Method	10,330 44— 47,
	10,330 71

REVERSE REPURCHASE

**AGREEMENTS—See Repurchase—
Reverse Repurchase Agreements**

RIGHTS

Completed-Contract Method	10,330 30
Contractors	10,330 22— 23
Partners	10,240 09
Percentage of Completion Method	10,330 22— 23
Personal Financial Statements	10,350 26,
	10,350 31

RISK

Business Risk	10,400 19
Collateral Loss	10,400 22— 25
Completed-Contract Method	10,330 52
Contractors	10,330 58— 60
Credit Risk	10,400 21— 23
Market Risk	10,400 20, 10,400 22
Medical Malpractice Claims	10,410 43
Option Writing	10,140 23— 25
Percentage of Completion Method	10,330 22, 10,330 28— 29
Real Estate Investment Trusts	10,060 08
Repurchase—Reverse Repurchase Agreements	10,400 18— 25

ROYALTIES

Nonprofit Organizations	10,250 074
-------------------------	------------

SALES

Form v. Substance	10,240 30
Nonprofit Organizations	10,250 027— 029,
	10,250 082, 10,250 084
Real Estate—See Real Estate Sales	
Real Estate Ventures	10,240 36— 38
Types of Contracts	10,330 14

SAVINGS AND LOAN ASSOCIATIONS

Disclosure	10,400 30
Investment Securities	10,400 30
Repurchase—Reverse Repurchase Agreements	10,380 06, 10,380 13— 14,
	10,400 01— 34

SCHOLARSHIPS AND FELLOWSHIPS

Remission of Tuition	10,020 10
----------------------	-----------

SCHOOLS

Financial Statements	10,250 129
----------------------	------------

SCIENTIFIC ORGANIZATIONS

Financial Statements	10,250 138
----------------------	------------

SCOPE OF EXAMINATION

Weakness in Internal Control	10,260 15
------------------------------	-----------

SECURITIES

Gain or Losses	10,360 01— 18
Investments of Banks	10,360 01— 18
Repurchase—Reverse Repurchase Agreements	10,400 01— 34
Security Interest	10,400 23

SECURITIES AND EXCHANGE

COMMISSION

ASR—See Accounting Series Releases	
Banks	10,360 01— 05
Open End Investment Companies	10,140 40
Regulation S-X	10,260 26, 10,360 03— 05

SELLING EXPENSES

Contract Costs	10,330 72
----------------	-----------

SELLING PRICE

Foreclosed Properties	10,060 17, 10,170 02
-----------------------	----------------------

SERVICES

Agency Relationships	10,330 58
Colleges and Universities	10,020 10
Contract Options	10,330 64
Contributions to Real Estate Ventures	10,240 30— 32
Donated	10,250 067— 070
Hospitals	10,340 02— 03
Nonprofit Organizations	10,250 027— 028,
	10,250 051, 10,250 084, 10,250 092— 07
Pricing Municipal Bonds	10,260 13— 15
Real Estate Ventures	10,240 37— 39
Specifications by Customers	10,330 01,
	10,330 11
Transactions	10,330 11
Types of Contracts	10,330 13— 15

**SHAREHOLDERS' EQUITY—See
Stockholders' Equity**

SOFTWARE—See Computer Software

SOLICITATION

Donated Services	10,250 069
Grants	10,250 096
Hospital-Related Organizations	10,340 09
Nonprofit Organizations	10,250 027,
	10,250 044, 10,250 054, 10,250 092

SPECIAL REPORTS

Nonprofit Organizations	10,250 002,
	10,250 007, 10,250 013

SPECIALISTS

Estimation of Current Value of Assets	10,350 14
--	-----------

STATEMENTS OF ACTIVITY

Affiliates of Nonprofit Organizations	10,250 090
Botanical Societies	10,240 141
Broadcasting Stations	10,250 136
Cemetery Organizations	10,250 130
Clubs	10,250 131
Foundations	10,250 135
Functional Classification	10,250 085— 087
Fund-Raising Activities	10,250 094
Investment Income	10,250 072— 076
Libraries	10,250 132
Museums	10,250 133
Nonprofit Organizations	10,250 016— 017,
	10,250 025— 031, 10,250 050— 052, 10,250 062—
	063, 10,250 066, 10,250 080, 10,250 120;
	10,250 123
Performing Arts Organizations	10,250 134
Religious Organizations	10,250 137
Research Organizations	10,250 138
Schools	10,250 129
Scientific Organizations	10,250 138
Trade Associations	10,250 139
Unions	10,250 140
Zoological Societies	10,250 141

**STATEMENTS OF ASSETS AND
LIABILITIES**

Call Options Outstanding	10,140 28
--------------------------	-----------

**STATEMENTS OF CHANGES IN
FINANCIAL POSITION**

Botanical Societies	10,250 141
Broadcasting Stations	10,250 136
Cemetery Organizations	10,250 130
Clubs	10,250 131
Foundations	10,250 135
Libraries	10,250 132
Museums	10,250 133

STATEMENTS OF CHANGES IN FINANCIAL POSITION—continued

Nonprofit Organizations	10,250 016— 017, 10,250 032— 034
Performing Arts Organizations	10,250 134
Real Estate Ventures	10,240 13
Religious Organizations	10,250 137
Research Organizations	10,250 138
Schools	10,250 129
Scientific Organizations	10,250 138
Trade Associations	10,250 139
Unions	10,250 140
Zoological Societies	10,250 141

STATEMENTS OF CHANGES IN FUND BALANCES

Educational Institution	10,020 11
Marketable Equity Securities	10,160 07
Nonprofit Organizations	10,160 14; 10,160 17 10,250 025, 10,250 104

STATEMENTS OF CHANGES IN NET ASSETS

Call Options Outstanding	10,140 28
Illustration	10,140 11— 12
Money-Market Funds	10,140 09— 13

STATEMENTS OF CHANGES IN NET WORTH

Form of Statement	10,350 06
Illustrations	10,350 34
Personal Financial Statements	10,350 06, 10,350 34

STATEMENTS OF FINANCIAL CONDITION

Form of Statement	10,350 06
Illustrations	10,350 34, 10,400 34
Income Taxes	10,350 06, 10,350 30
Mortgage-Backed Securities	10,400 31
Personal Financial Statements	10,350 06, 10,350 22, 10,350 30, 10,350 34
Provision for Estimated Income Taxes	10,350 06, 10,350 30— 31, 10,350 35

STATEMENTS OF FINANCIAL POSITION

Annuity Gifts	10,250 121
Botanical Societies	10,250 141
Broadcasting Stations	10,250 136
Cemetery Organizations	10,250 130
Classified	10,250 023— 024
Clubs	10,250 131
Collections	10,250 113— 115
Completed-Contract Method	10,330 30
Depreciation	10,250 106— 112
Educational Institutions	10,020 11, 10,250 129
Fixed Assets	10,250 105— 112
Foundations	10,250 135
Interfund Borrowings	10,250 118— 119
Investment Pools	10,250 116— 117
Libraries	10,250 132
Losses on Contracts	10,330 89
Marketable Equity Securities	10,160 07, 10,160 12— 14
Museums	10,250 133
Nonprofit Organizations	10,250 016— 017, 10,250 019— 024, 10,250 052, 10,250 062, 10,250 079, 10,250 105— 123
Percentage of Completion Method	10,330 80
Performing Arts Organizations	10,250 134
Pledges Receivable	10,250 065— 066
Real Estate Investment Trusts	10,060 28
Real Estate Ventures	10,240 06
Religious Organizations	10,250 137
Research Organizations	10,250 138
Scientific Organizations	10,250 138
Trade Associations	10,250 139
Unions	10,250 140

STATEMENTS OF FINANCIAL POSITION—continued

Zoological Societies	10,250 141
----------------------	------------

STATEMENTS OF INCOME—See Income Statements**STATEMENTS OF OPERATIONS**

Call Options Outstanding	10,140 28
Money-Market Funds	10,140 14, 10,140 18

STATEMENTS OF POSITION (AICPA)

No 74-8	10,020 01— 12
No 74-11	10,030 01— 08
No 75-2	10,060 01— 55
No 76-3	10,130 01— 15
No 77-1	10,140 01— 46
No 78-1	10,160 01— 17
No 78-2	10,170 01— 06
No 78-9	10,240 01— 41
No 78-10	10,250 001— 141
No 79-1	10,260 01— 40
No 81-1	10,330 01— 94
No 81-2	10,340 01— 16
No 82-1	10,350 01— 35
No 83-1	10,360 01— 18
No 85-1	10,370 01— 25
No 85-2	10,380 01— 39
No 85-3	10,390 001— 107
No 86-1	10,400 01— 34
No 87-1	10,410 01— 77

STATEMENTS OF REVENUE AND EXPENSE

Marketable Equity Securities	10,160 06— 09, 10,160 12— 14
------------------------------	---------------------------------

STATEMENTS ON AUDITING STANDARDS

No 6	10,340 09
------	-----------

STEWARDSHIP—See Accountability**STOCKHOLDERS' EQUITY**

Obligation of ESOPs	10,130 07— 08
---------------------	---------------

SUBSCRIPTION INCOME

Nonprofit Organizations	10,250 084
-------------------------	------------

SUBSEQUENT EVENTS

Gains or Losses on Investments	10,160 13
Percentage of Completion Method	10,330 82

SUBSIDIARIES

Definition	10,240 05
Real Estate Ventures	10,240 05— 07, 10,240 10, 10,240 28

SUMMARIZATION

Hospital-Related Organizations	10,340 10— 11
--------------------------------	---------------

SUPPLEMENTARY INFORMATION

Money-Market Funds	10,140 14— 17
Nonprofit Organizations	10,250 088
Personal Financial Statements	10,350 04

SUPPORT

Annuity Gifts	10,250 121
Definition	10,250 126
General Public	10,250 085, 10,250 094
Nonprofit Organizations	10,250 025— 031, 10,250 034, 10,250 050, 10,250 054— 071

TAX REFORM ACT OF 1976

Municipal Bond Funds	10,260 01 10,260 35
----------------------	---------------------

TAXES

Income—See Income Taxes	
Nonprofit Organizations	10,250 103
Real Estate—See Real Estate	
Tax Anticipation Notes	10,260 08

TAX-EXEMPT DEBT

Health Care Entities	10,370 02— 25
Municipal Bonds—See Municipal Bond Funds	
Revenue Bonds	10,370 02— 03

TAX-EXEMPT REVENUE

Allocation of Expenses	10,260 39
Distribution to Shareholders	10,260 01,
	10,260 29; 10,260 38
Real Estate Ventures	10,240 06—08
Undistributed Income	10,260 33—34

TERMINOLOGY

Accessions	10,250 126
Advances	10,390 002
Agricultural Cooperatives	10,390 006—022
Agricultural Producers	10,390 003—005
Annuity Gifts	10,250 126
Asserted Claims	10,410 10
Assets	10,020 10
Assigned Amounts	10,390 002
Auxiliary Activity	10,250 126
Breakage	10,380 25
Capital Additions	10,250 126
Cash Advance Method	10,390 002
Collections	10,250 126
Commercial Production	10,390 002
Commitment Fees	10,060 39
Completed-Contract Method	10,330 04
Construction Loans	10,060 04
Contractors	10,330 16
Contracts	10,330 12
Control	10,240 05, 10,250 042
Cooperatives	10,390 010
Cost-Type Contracts	10,330 15, 10,330 93
Crop Development Costs	10,390 002
Crops	10,390 002
Current Funds	10,020 10
Custodian Funds	10,250 126
Deaccessions	10,250 126
Depreciation	10,250 106
Designated Funds	10,250 126
Development Loans	10,060 04
Dollar Repurchase Agreements	10,380 07—08
Dollar Reverse Repurchase Agreements	10,380 07—08
Donor-Restricted Funds	10,370 07
Employee Stock Ownership Plan	10,130 01
Encumbrances	10,250 126
Endowment Funds	10,250 126
Estimated Current Amount of Liabilities	10,350 27
Estimated Current Value of Assets	10,350 12
Exempt and Nonexempt Cooperatives	10,390 002
Expendable Funds	10,250 126
Face-Amount Certificate Companies	10,030 02—06
Face-Amount Certificates	10,030 03
Farm Price Method	10,390 002
Fixed Price Contracts	10,330 15, 10,330 93
Functional Classification Funds	10,250 126
Funds Whose Use Is Limited	10,370 07
Futures Contract	10,390 002
Gap Loans	10,060 04
General Funds	10,370 07—10
General Obligation Bonds	10,260 06
General Partnerships	10,240 01
Grove	10,390 002
Growing Crop	10,390 002
Harvested Crop	10,390 002
Hospital-Related Organizations	10,340 09
Indenture	10,370 07
Industrial Revenue Bonds	10,260 05
Investment Companies	10,030 01—06, 10,140 04
Investment Pool	10,250 126
Junior Mortgage Loans	10,060 04
Land Acquisition Loans	10,060 04
Liabilities	10,020 10
Life Income Agreement	10,250 126

TERMINOLOGY—continued

Limited Partnerships	10,240 01
Livestock	10,390 002
Loan Funds	10,250 126
Market Order Prices	10,390 002
Marketable Equity Securities	10,160 03
Marketing Cooperatives	10,390 002
Matrix Pricing	10,260 18
Medical Malpractice Claims	10,410 05
Money-Market Funds	10,140 04
Net Realizable Value	10,390 002
Net Worth	10,350 06
Nonprofit Organizations	10,250 004, 10,250 126
Orchard	10,390 002
Patron	10,390 002
Patronage	10,390 002
Patronage Allocations	10,390 002
Patronage Earnings	10,390 002
Percentage of Completion Method	10,330 04
Pledges	10,250 126
Pools	10,390 002
Profit Centers	10,330 17
Progeny	10,390 002
Purchase Leaseback	10,060 04
Put and Call Options	10,140 22
Quasi-Endowment Funds	10,250 126
Raised Animals	10,390 002
Realization	10,330 03
Recurring Land Development Costs	10,390 002
Repurchase Agreements	10,380 05—06
Restricted Funds	10,250 126
Retains	10,390 002
Revenue Bonds	10,260 06, 10,370 07
Revenues	10,250 126
Reverse Repurchase Agreements	10,380 05—06
Statements of Changes in Net Worth	10,350 06
Statements of Financial Condition	10,350 06
Subsidiary	10,240 05
Supply Cooperatives	10,390 002
Support	10,250 126
Term Endowment	10,250 126
Time-and-Material Contracts	10,330 15, 10,330 93
Troubled Debt Restructuring	10,170 03
Unasserted Claims	10,410 10
Undivided Interests	10,240 01
Unit Livestock Method	10,390 002
Unit Price Contracts	10,330 15, 10,330 93
Units-of-Delivery Method	10,330 04
Unrestricted Funds	10,250 126
Vineyards	10,390 002
Warehousing Loans	10,060 04
Wrap-Around Loans	10,060 04
Written Notice of Allocation	10,390 002

TIME-AND-MATERIAL CONTRACTS

Definition	10,330 15, 10,330 93
Description of Types	10,330 93
Estimation of Revenue	10,330 56

TIME PERIODS

Completed-Contract Method	10,330 30—31
Construction-Type Contracts	10,330 02
Percentage of Completion Method	10,330 43—51, 10,330 79—81
Production-Type Contracts	10,330 02

TIME VALUE OF MONEY

Medical Malpractice Claims	10,410 30—32
Personal Financial Statements	10,350 16, 10,350 22, 10,350 24—29
Present Value—See Present Value	

TIMING DIFFERENCES

Employee Stock Ownership Plans	10,130 15
Nonprofit Organizations	10,250 103
Real Estate Ventures	10,240 06—08, 10,240 40

TITLES TO PROPERTY—See Property Titles**TRADE ASSOCIATIONS**

Donated Services	10,250 067
Financial Statements	10,250 139

TRANSACTIONS

Estimated Current Value of Assets	10,350 13
Hospital-Related Organizations	10,340 11—12
Intercompany—See Intercompany Transactions	
Interfund—See Interfund Transactions	
Real Estate Ventures	10,240 25, 10,240 30
Service	10,330 11

TRANSFERS BETWEEN FUNDS—See Interfund Transactions**TRUSTS**

Collective—See Collective Trust Funds	
Medical Malpractice Claims	
Accrual	10,410 16, 10,410 19, 10,410 66—75
Nonprofit Organizations	10,250 005, 10,250 122
Personal Financial Statements	10,350 26
Real Estate Investment—See Real Estate Investment Trusts	
Unit Investment—See Unit Investment Trusts	

TUITION

Colleges and Universities	10,020 10
---------------------------	-----------

UNBILLED RECEIVABLES

Colleges and Universities	10,020 10
Defined as Assets	10,020 10

UNCERTAINTIES

Collectability of Loans Receivable	10,240 34
Construction-Type Contracts	10,330 04, 10,330 10
Interest Revenue Recognition	
Discontinued	10,060 30
Percentage of Completion Method	10,330 26—29, 10,330 53—55
Performance of Contracts	10,330 02
Production-Type Contracts	10,330 04, 10,330 10
Sales of Services	10,240 37

UNDERWRITERS

Municipal Securities	10,260 19—20
----------------------	--------------

UNDIVIDED INTERESTS

Claims	10,240 18—19
Definition	10,240 01
Real Estate Ventures	10,240 11, 10,240 18—19

UNEARNED INCOME—See Deferred Income**UNINCORPORATED ENTITIES**

Nonprofit Organizations	10,250 046—047
Partnerships—See Partnerships	

UNIONS

Donated Services	10,250 067
Financial Statements	10,250 140

UNIT INVESTMENT TRUSTS

Municipal Bond Funds	10,260 01—03, 10,260 16, 10,260 21
Tax Status	10,260 29, 10,260 35

UNIT PRICE CONTRACTS

Definition	10,330 15, 10,330 93
Description of Types	10,330 93
Estimation of Revenue	10,330 56

UNITED STATES OFFICE OF EDUCATION

Higher Education Finance Manual	10,020 03
---------------------------------	-----------

UNITS-OF-DELIVERY METHOD

Combining Contracts	10,330 38
Definition	10,330 04
Revenue Recognition	10,330 44—47, 10,330 71
Segmenting Contracts	10,330 42

UNIVERSITIES—See Colleges and Universities**UNREALIZED APPRECIATION**

Investments, Nonprofit	
Organizations	10,250 075, 10,250 083
Marketable Equity Securities	10,160 12—15
Money-Market Funds	10,140 14—16, 10,140 19—20
Municipal Bond Funds	10,260 31
Options	10,140 28
Real Estate Ventures	10,240 14, 10,240 26

UNREALIZED DEPRECIATION

Investments, Nonprofit	
Organizations	10,250 083
Marketable Equity Securities	10,160 12—15
Money-Market Funds	10,140 14—16, 10,140 19—20
Municipal Bond Funds	10,260 31
Options	10,140 28

UNRESTRICTED FUNDS

Colleges and Universities	10,020 10—12
Combined Financial Statements	
Definition	10,250 045
General Funds—See General Funds	
Hospitals—See General Funds	
Investment Income	10,250 072—076
Nonprofit Organizations	10,250 020—024, 10,250 045, 10,250 060, 10,250 063, 10,250 120

USEFUL LIFE

Collections	10,250 115
Personal Financial Statements	10,350 31
Relation to Depreciation	10,250 106—107, 10,250 112

USERS

Assessing Business Risks	10,330 28
Financial Statements of Nonprofit Organizations	10,250 008—010, 10,250 030—033, 10,250 043, 10,250 094
Forecasts—See Forecasting	
Personal Financial Statements	10,350 01—03

VALUATION

Allowances—See Allowances, Valuation	
Donated Services	10,250 067—070
Estimated Current Amount of Liabilities	10,350 12—13, 10,350 15, 10,350 27—30
Estimated Current Value of Assets	10,350 12—26, 10,350 30
Fixed Assets	10,250 105
Foreclosed Property	10,060 13, 10,060 26—27, 10,060 53—54, 10,170 01—06
Investments, Nonprofit	
Organizations	10,250 077—083
Investments, Short-Term	10,140 02, 10,140 46

VALUATION—continued

Materials Donated	10,250.071
Matrix Pricing—See Matrix Pricing	
Municipal Bonds	10,260.03, 10,260.10—28
Property Donated	10,250.071
Put and Call Options	10,140.28
Real Estate—See Real Estate	

VOLUNTARY HEALTH AND WELFARE

ORGANIZATIONS

Restricted Funds	10,250.055
----------------------------	------------

VOLUNTEERS

Donated Services	10,250.067—070
----------------------------	----------------

WAREHOUSING LOANS

Definition	10,060.04
----------------------	-----------

WORK IN PROCESS

Percentage of Completion Method	10,330.22—29
---	--------------

WRITE-DOWNS

Investments, Nonprofit Organizations	10,250.077
Marketable Equity Securities	10,160.14

YIELD—See Return on Investment

ZOOLOGICAL SOCIETIES

Financial Statements	10,250.141
--------------------------------	------------

STATEMENTS OF POSITION AUDITING STANDARDS DIVISION

Introduction

Statements of Position of the Auditing Standards Division are issued to revise or clarify certain recommendations in industry-oriented audit guides or areas to which they relate. Statements of Position of the Auditing Standards Division have the same authority as that of an audit guide. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations.

➡ The next page is 30,211. ←

AUD Section 11,000

STATEMENTS OF POSITION

AUDITING STANDARDS

DIVISION

TABLE OF CONTENTS

Section	Paragraph
11,010 Revision of Form of Auditor's Report (7/74) . . . .	.01-.12
Effects of Variances From Generally Accepted Account- ing Principles Have Been Determined . . . . .	.04-.08
Effects of Variances From Generally Accepted Account- ing Principles Have Not Been Determined . . . . .	.09
Opinions on Presentations in Conformity With Regula- tory Practices . . . . .	.10-.11
Effective Date . . . . .	.12
[11,020] Audits of Brokers and Dealers in Securities (12/76) [Withdrawn by inclusion in the AICPA Audit and Accounting Guide, <i>Audits of Brokers and Dealers in Securities</i> , 1985]	
11,030 Clarification of Accounting, Auditing, and Reporting Practices Relating to Hospital Malpractice Loss Contingencies (3/78) . . . . .	.01-.28
Introduction . . . . .	.01
Background . . . . .	.02-.07
Auditing Procedures . . . . .	.08-.16
Accounting and Disclosure . . . . .	.17-.25
Reporting Considerations . . . . .	.26-.28
11,040 Confirmation of Insurance Policies in Force (8/78) .01-.05	
Effective Date . . . . .	.05
[11,050] Report on a Financial Feasibility Study (10/82) [Superseded by the AICPA Guide for Prospec- tive Financial Statements, 1986]	

<i>Section</i>	<i>Paragraph</i>
11,060 Auditing Property and Liability Reinsurance	
(10/82)	.01-.23
Introduction	.01-.08
Applicability and Scope	.08
Ceded Reinsurance	.09-.13
Internal Controls of the Ceding Company	.09-.10
Auditing Procedures	.11-.13
Assumed Reinsurance	.14-.19
Internal Controls of the Assuming Company	.14-.15
Auditing Procedures	.16-.18
Pools, Associations, and Syndicates	.19
Reinsurance Intermediaries	.20-.22
Effective Date	.23
11,070 Auditing Life Reinsurance (11/84)	.01-.25
Applicability	.01
Introduction	.02-.13
Generally Accepted Accounting Principles	.11-.12
Scope	.13
Ceded Reinsurance	.14-.19
Internal Controls of the Ceding Company	.14-.15
Auditing Procedures	.16-.19
Assumed Reinsurance	.20-.24
Internal Controls of the Assuming Company	.20-.21
Auditing Procedures	.22-.24
Effective Date	.25

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Section 11,010**Revision of Form of Auditor's Report**

July 1974

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 these guides, AICPA task forces 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 task force.

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 such matters, members should be aware that they may be called upon to justify departures from the recommendations of the task force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the task force 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 task force believes would be in the public interest.

Audits of Fire and Casualty Insurance Companies

.01 The AICPA issued in 1966 the industry audit guide, *Audits of Fire and Casualty Insurance Companies*. Chapter 9 of that guide included recommendations on the form of the auditor's report. In December 1972, the AICPA issued an industry audit guide entitled *Audits of Stock Life Insurance Companies*. The recommendations on the form of the auditor's report in that guide varied from the recommendations set forth in the fire and casualty audit guide. It is the considered judgment of the

AICPA Insurance Auditing Task Force that the portion of chapter 9 on pages 58 through 64 of the fire and casualty audit guide that deals with the form of the auditor's opinion should be revised; that portion is superseded by this Statement of Position.

.02 The preferable method of financial statement presentation to avoid the need for qualification of the auditor's report is to present the financial statements in accordance with generally accepted accounting principles.

.03 When the financial statements of fire and casualty insurance companies, used for purposes other than filing with regulatory authorities, have been prepared in conformity with regulatory practices, the independent auditor should follow the requirement of section 544.02 of SAS No. 1 that—

. . . material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or an adverse opinion on such statements. However, an adverse opinion may be accompanied by . . . [an opinion] . . . on any supplementary data furnished which are fairly presented in conformity with generally accepted accounting principles.

Independent auditors' reports which might be used are illustrated below.

Effects of Variances From Generally Accepted Accounting Principles Have Been Determined

.04 *Qualified Opinion.* When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of the variances from generally accepted accounting principles are sufficiently material to require a qualified opinion, the auditor's report might be worded as follows:

We have examined the balance sheet of X Company as of December 31, 19____, and the related statements of income, changes in surplus and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other

auditing procedures as we considered necessary in the circumstances.

The Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of _____. The effects on the accompanying financial statements of the variances between such practices and generally accepted accounting principles are described in Note X.¹

In our opinion, except for the effects of the matters referred to in the preceding paragraph, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19____, and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.05 If a statement of changes in financial position on a statutory basis is not presented, the omission should be dealt with in accordance with sections 545.04 and .05 of SAS No. 1.

.06 *Adverse Opinion.* When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of the variances from generally accepted accounting principles are so material that, in the independent auditor's judgment, a qualified opinion is not justified, an adverse opinion will be required. The adverse opinion will usually be followed by an opinion on any supplementary data presented in conformity with generally accepted accounting principles. When such data are presented separately, rather than in notes to the financial statements, the scope paragraph of the independent auditor's report should be expanded to include references to supplementary data and a second paragraph should be added referring to the variances from generally accepted accounting principles worded as in the prior example. The opinion paragraph might be worded as follows:

It is our opinion that, because of the materiality of the effects of the differences between generally accepted accounting principles and the accounting practices referred to in the preceding paragraph, the aforementioned financial statements do not present fairly the financial position of X Company at December 31, 19____, or the results of its operations or changes in its financial position for the year then ended, in

¹ If the effects of the variances are not described in a note, they should be set forth in this paragraph.

conformity with generally accepted accounting principles. It is our opinion, however, that the statements of adjustments to arrive at stockholders' (members') equity and net income present fairly stockholders' (members') equity at December 31, 19____, and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.07 When the supplementary data are included in a note to the financial statements, the last sentence of the opinion would read as follows:

It is our opinion, however, that the supplementary data included in Note X present fairly the stockholders' (members') equity at December 31, 19____, and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.08 *Variances Not Affecting All Financial Statements.* When the effects of variances from generally accepted accounting principles are material to one or more but not all of the financial statements, the auditor's report may include an unqualified opinion on the statements not so affected.

Effects of Variances From Generally Accepted Accounting Principles Have Not Been Determined

.09 When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of variances from generally accepted accounting principles have not been determined by the company, the auditor should generally be able to reasonably estimate whether such effects (a) would be immaterial so as to permit issuance of an unqualified opinion, (b) would be sufficiently material to require issuance of a qualified opinion, or (c) would be so material as to require issuance of an adverse opinion. In reporting, the auditor should then follow the appropriate form recommended above. If the auditor is not able to reasonably estimate the effects of variances, he should disclaim an opinion; his report might read as follows:

(Standard scope paragraph)

The Company presents its financial statements in conformity with the accounting practices prescribed or permitted by the

Insurance Department of the State of _____. The variances between such practices and generally accepted accounting principles are described in Note X.² The effects of such variances on the accompanying financial statements have not been determined. Therefore, we do not express any opinion on the aforementioned financial statements as to fair presentation of financial position or results of operations or changes in financial position in conformity with generally accepted accounting principles.

Opinions on Presentations in Conformity With Regulatory Practices

.10 Section 544.04 of SAS No. 1 states that—

In instances where the financial statements of regulated companies purport to be primarily presentations in accordance with prescribed accounting regulations, the independent auditor may also be asked to report upon their fair presentation in conformity with such prescribed accounting. There is no objection to the independent auditor's report containing such an opinion provided that the first standard of reporting is also observed by the issuance of a qualified or adverse opinion, as required by the circumstances.

.11 When the auditor is asked to report in this manner, he may do so by adding the following opinion to the concluding paragraph of any prior examples:

It is our opinion, however, that the aforementioned financial statements present fairly the financial position of X Company at December 31, 19____, and the results of its operations and changes in its financial position for the year then ended in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of _____, applied on a basis consistent with that of the preceding year.

Effective Date

.12 The Insurance Auditing Task Force recommends that the foregoing reporting be applied with respect to auditors' reports on financial statements of fire and casualty insurance companies for periods ending after September 30, 1974, and encourages earlier application.

² If the variances are not described in a note to the financial statements, they should be set forth in this paragraph.

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»»»→ *The next page is 30,273.* ←«««

Section 11,030

**Clarification of Accounting, Auditing,
and Reporting Practices Relating to
Hospital Malpractice Loss
Contingencies**

March 1, 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 these guides, AICPA subcommittees or task forces 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 subcommittee or task force.

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 such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force 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 subcommittee or task force believes would be in the public interest.

Hospital Audit Guide**Introduction**

.01 In 1972, the AICPA issued the industry audit guide, *Hospital Audit Guide*. Chapter 5 of that guide includes suggested auditing procedures relating to claims against a hospital for negligence and malpractice, including possible disclosure of contingent liabilities. The size of current malpractice claim settlements, the substantial increase in malpractice insurance rates, the increasing practice of hospitals to reduce or terminate malpractice liability coverage, and other factors are conditions that differ significantly from those

prevailing at the time the guide was issued. The AICPA Subcommittee on Health Care Matters believes that item five on page 25 of the guide should be superseded and replaced by this statement of position.

Background

.02 Over the years, hospital malpractice risks were generally covered by insurance on an occurrence basis¹ at reasonable costs. Insurers found the business desirable and actively competed for it. Medicare, Medicaid, and other third-party payors have long recognized the premiums for such insurance as allowable costs of conducting the operations of a hospital.

.03 The major changes that have taken place in hospital malpractice insurance have resulted from the changing social climate in the United States. Increased emphasis on consumerism and greater public awareness of the possibility of bringing suit, among other factors, have created an entirely new environment for malpractice claims. In this environment, professionals and institutions are being treated somewhat as guarantors of the success of their efforts. Juries in court cases are disposed to awarding large amounts of money, and suits brought by individuals on reaching their majority for occurrences during their infancy have added to the problems in this area. As a result, malpractice costs have increased significantly.

.04 Insurers reacted in varying ways—by reducing or attempting to reduce the limits of their liability (for example, switching from occurrence to claims-made policies,² lowering limits on policies, and offering policies with very large deductibles), by raising premiums, and by refusing to renew policies and withdrawing from this aspect of the insurance business.

.05 Hospitals, too, reacted in a variety of ways to control the cost of malpractice insurance. Some assumed or increased deductibles in basic policies, thus becoming partially uninsured. Others chose to cancel all malpractice coverage, thus becoming totally uninsured. Hospital groups throughout the country formed captive insurance companies; however, due to insufficient experience the premiums are retrospective in many cases.

¹ A policy that insures for incidents that occur during the period of coverage is on an "occurrence" basis.

² A policy that insures for claims made during the period of coverage is on a "claims-made" basis.

.06 Some insurance commissioners have tried to force insurers to continue to insure malpractice risks, but many major insurers have withdrawn. Several state legislatures have passed laws limiting the liability of the providers and requiring an arbitration-like procedure relating to malpractice cases. However, at least one such law has been declared unconstitutional.

.07 It appears that one of the reasons for the withdrawal of insurers from this business is the difficulty of estimating potential losses. This may tend to diminish as improved estimation techniques are developed and as claims settled under present conditions become part of the body of experience. The effect of inflation represents an additional variable which complicates the process of estimating losses.

Auditing Procedures

.08 Auditors should give particular attention to whether loss contingencies resulting from malpractice risks have been accrued for and disclosed in accordance with the requirements of FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*.

.09 In evaluating the reasonableness of the accrual for estimated losses from malpractice claims, the auditor should include in his consideration the amount of insurance coverage, the insurance adjuster's evaluation of known claims, the financial reputation of the insurer, the type of coverage (claims-made or occurrence), the amount of the deductible provisions, the possibility of retrospective adjustments, and related legal and other costs.

.10 With respect to litigation, claims, and assessments, paragraph 4 of Statement on Auditing Standards No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, states that the independent auditor should obtain evidential matter relevant to the following factors:

- The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments.
- The period in which the underlying cause for legal action occurred.
- The degree of probability of an unfavorable outcome.
- The amount or range of potential loss.

.11 In addition, the auditor should apply the procedures outlined in paragraphs 5 and 6 of SAS No. 12, which are summarized below:

- Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management a description and evaluation of litigation, claims, and assessments.
- Examine documents in the client's possession concerning litigation, claims, and assessments.
- Obtain assurance from management that it has disclosed all unasserted claims that the lawyer has advised are probable of assertion and must be disclosed in accordance with FASB Statement No. 5.
- Request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.12 The independent auditor's examination normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments, such as reading minutes of meetings, contracts, agreements, and correspondence, and inspecting other pertinent documents (SAS No. 12, paragraph 7). Attention should also be given to internal controls and procedures related to identifying malpractice incidents.

.13 A letter of audit inquiry to the lawyer handling the claims is the auditor's primary means of obtaining corroboration of the information furnished by management concerning claims made and known incidents for which claims have not been made that are either uninsured or in excess of insurance coverage. SAS No. 12 should be followed to solicit legal counsel's evaluation of the likelihood of an unfavorable outcome of litigation, claims, and assessments and his estimate, if one can be made, of the amount or range of potential loss.

.14 As to unasserted claims, paragraph 30 of FASB Statement No. 5, *Accounting for Contingencies*, indicates there should be a provision for

uninsured losses resulting from injury to others or damage to the property of others that took place prior to the date of the financial statements, even though the enterprise may not become aware of those matters until after that date, if the experience of the

enterprise or other information enables it to make a reasonable estimate of the loss that was incurred prior to the date of its financial statements.

It would be appropriate for the auditor to consider prior estimates and prior loss experience, analyses of the frequency of past claims, and other actuarial considerations in evaluating the reasonableness of management's estimate of the loss (if any) that was incurred with respect to unasserted claims before the date of the financial statements. Although the experience of an individual hospital may not be statistically significant, the experience of larger units of similar character or of aggregates of similar institutions may be a useful guide.

.15 When the hospital's malpractice risks are insured on a claims-made basis, the auditor should obtain a written representation from management, if applicable, that it intends to renew the hospital's malpractice insurance coverage on a claims-made basis and that it has no reason to believe that the hospital may be prevented from renewing such coverage.

.16 The cancellation (or termination) of claims-made malpractice insurance coverage will generally cause the hospital to be at risk for all unreported incidents that occurred during the term of the cancelled policy unless, at cancellation, coverage was obtained for such incidents. Such cancellation may give rise, therefore, to a liability for unreported incidents that occurred prior to cancellation. Since terms for notifying the carrier of malpractice incidents vary, the policy should be reviewed for specific requirements.

Accounting and Disclosure

.17 The estimated loss contingency resulting from malpractice risks should be accrued for and disclosed in conformity with the provisions of FASB Statement No. 5 and FASB Interpretation No. 14. A loss contingency should be accrued for if an incident of malpractice has occurred that results in a probable loss that can be reasonably estimated. Current circumstances may make it difficult to estimate the amount of the loss. A qualified actuary may be helpful both in deriving estimates of losses incurred but not reported and in quantifying the uncertainties inherent in such estimates.³

³ In such circumstances, the independent auditor should be guided by the provisions of SAS No. 11, *Using the Work of a Specialist*.

.18 If the hospital has exposure to material malpractice contingencies in excess of amounts accruable under FASB Statement No. 5 and FASB Interpretation No. 14, such contingencies should be disclosed in accordance with paragraphs 9 through 11 of FASB Statement No. 5.

.19 Because of the significance of malpractice risks and the related costs, disclosure of a hospital's policy with regard to malpractice insurance coverage and changes in that policy may be necessary for presentation of the financial statements in conformity with generally accepted accounting principles. If premiums are determined retrospectively, disclosure of that fact may be necessary. Particular attention should be paid to paragraphs 44 and 45 of FASB Statement No. 5 if a hospital or group of hospitals insures malpractice risks through a captive or joint insurance company or if a hospital's malpractice insurance premiums are determined retrospectively.

.20 FASB Statement No. 5 requires disclosure of unasserted claims only if it is probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable. Because of the significance of malpractice risks to hospitals, the Subcommittee on Health Care Matters recommends that hospitals also disclose in their financial statements the possibility of losses from unasserted claims that do not meet those criteria.

.21 An example of appropriate financial statement disclosure of uncertainties arising from possible malpractice follows.

Malpractice claims in excess of insurance coverage have been asserted against the hospital by various claimants. The claims are in various stages of processing and some may ultimately be brought to trial. Counsel is unable to conclude about the ultimate outcome of the actions. There are known incidents occurring through (balance sheet date) that may result in the assertion of additional claims, and other claims may be asserted arising from services provided to patients in the past. The hospital is unable to estimate the ultimate cost, if any, of the settlement of such potential claims and, accordingly, no accrual has been made for them.

.22 If the hospital has changed its malpractice insurance coverage from an occurrence basis policy to a claims-made policy, it may be appropriate to disclose the related facts and circumstances in the financial statements. The following is an example of such disclosure.

Effective January 1, 19XX, the hospital changed its malpractice insurance coverage from an occurrence basis policy to a claims-made policy. Claims based on occurrences prior to January 1, 19XX, are insured under the old policy. Should the claims-made policy not be renewed or replaced with equivalent insurance, claims based on occurrences during its term but reported subsequently will be uninsured.

.23 In the first year a hospital is uninsured for its malpractice risks to any material degree, whether by use of deductibles or otherwise, the related facts and circumstances should be described in the financial statements. Such disclosure should include the effect on comparability of insurance expense in the year of change. The following is an example of such disclosure.

The hospital has terminated its malpractice coverage as of the beginning of the current year. In the prior year, malpractice insurance premiums in the amount of \$_____ were charged to income. During the current year, no charges for premiums or for actual or potential claims have been made.

.24 Information may become available after the balance sheet date, but before the issuance of the auditor's report, indicating that it was probable that a malpractice loss had been incurred as of the balance sheet date. When the amount of the loss can be reasonably estimated, it should be accrued by a charge to income (see paragraph 8 of FASB Statement No. 5). An example would be the filing of a claim after the balance sheet date which relates to services rendered prior to that date. Information may become available after the balance sheet date, but before the issuance of the auditor's report, which may require disclosure so that the financial statements will not be misleading (see paragraph 11 of FASB Statement No. 5). An example of a subsequent event that may require disclosure is the termination of a hospital's malpractice insurance coverage.

.25 Malpractice loss amounts eligible for reimbursement by third-party payors may be materially different from amounts accruable under FASB Statement No. 5. Recognition should be given to the effect of timing differences that may result.⁴ In addition, any restrictions on funds required to be set aside should be disclosed.

⁴ See page 5 of the *Hospital Audit Guide* for the discussion, "Third-Party Reimbursement Timing Differences."

Reporting Considerations

.26 If the estimated loss arising from alleged malpractice is accrued for and disclosed in conformity with the provisions of paragraphs 8 through 11 of FASB Statement No. 5 and FASB Interpretation No. 14, and if there is no material exposure to losses from claims and potential claims in excess of the amount accrued, or if all claims and potential claims are adequately covered by insurance, the auditor should not modify his report with respect to such claims.

.27 Statement on Auditing Standards No. 2, paragraph 15, states that the auditor should express a qualified or an adverse opinion when financial statements examined in accordance with generally accepted auditing standards are materially affected by a departure from generally accepted accounting principles. The following is an example of a modification of the auditor's report, along with an example of appropriate financial statement disclosure, when a hospital makes a provision for malpractice losses that is materially different from the amount that should be accrued under FASB Statement No. 5 and FASB Interpretation No. 14.

(Scope Paragraph—Standard Wording)
(Separate Paragraph)

As described in Note X, claims for alleged malpractice in excess of insurance coverage have been asserted against the hospital by various claimants, and additional material claims may be asserted arising from services provided to patients in the past. The hospital has charged income with a provision of \$_____ for losses related to uninsured malpractice claims. The ultimate liability of the hospital resulting from such claims is not presently determinable. Generally accepted accounting principles preclude a charge to income for a provision for loss contingencies that cannot be reasonably estimated.

(Opinion Paragraph)

In our opinion, except for the effect of recording a provision for losses related to malpractice claims which cannot be reasonably estimated, the financial statements referred to above present fairly . . . in conformity with generally accepted accounting principles. . . .

(Financial Statement Disclosure)

Malpractice claims in excess of insurance coverage have been asserted against the hospital by various claimants, and additional claims may be asserted for known incidents through (balance sheet date). The claims are in various stages of processing and some may ultimately be brought to trial. Counsel is unable to

conclude about the ultimate outcome of the actions commenced. Moreover, additional material claims arising from services provided to patients in the past may be asserted. The hospital is unable to estimate the ultimate cost of the settlement of such potential claims. Although the amount of the losses from uninsured malpractice claims cannot be reasonably estimated, the hospital considers it prudent to record a provision for such losses and accordingly has charged income with a provision of \$_____.

.28 The auditor should consult relevant statements on auditing standards to determine the need, if any, for otherwise modifying his report because of malpractice contingencies.

Subcommittee on Health Care Matters

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The subcommittee gratefully acknowledges the contributions made to the development of this Statement of Position by former members of the subcommittee Robert A. Cerrone, William Freitag, Robert A. Jordan, Robert F. Rosenstiel, and Allen J. Winick, and by former AICPA staff aide to the subcommittee, Edward J. Mazur.

»»→ **The next page is 30,293.** ←««

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* (page 32), 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 pages 31-34, 46-47, and 96 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 examined 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.

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 examinations made in accordance with generally accepted auditing standards for periods ending on or after December 31, 1978.

Insurance Companies Committee

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➡ The next page is 30,319. ⬅

Section 11,060

Auditing Property and Liability Reinsurance

**Supplements Audits of Fire
and Casualty 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 industry audit guide, *Audits of Fire and Casualty 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 Industry Audit Guide, *Audits of Fire and Casualty Insurance Companies*, pages 5–8.)

.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.¹

.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

¹ 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.”

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, 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 accounting control regarding ceded reinsurance and assumed reinsurance and describe the related auditing procedures. SAS No. 1, section 320.31, states, “The establishment and maintenance of a system of internal control is an important responsibility of management.” 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.

Ceded Reinsurance

Internal Controls of the Ceding Company

.09 The ceding company should have those internal accounting control 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 adequacy of internal accounting controls 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.

.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 the study and evaluation of internal control, 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.

.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 system of internal accounting control.² If the auditor decides not to rely on the company's control procedures, 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. 2, paragraphs 10-13). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.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:

² SAS No. 1, section 320, states, "A material weakness is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions" (as amended by SAS No. 30). SAS No. 20 requires the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that the auditor becomes aware of through his examination

- a. Read the reinsurance contract and related correspondence to—
 - Obtain an understanding of the business objective of the reinsurance contract, and
 - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60, paragraph 40 (see paragraph 7, 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 system of internal accounting control 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 accounting controls relating to ceded reinsurance (see SAS No. 30, *Reporting on Internal Accounting Control*, paragraphs 60–61).

.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 adequacy of internal accounting controls 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.

Auditing Procedures

.16 In the study and evaluation of internal control, 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.

.17 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 system of internal accounting control.³ If the auditor decides not to rely on the company's control procedures, 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 a special-purpose report from the ceding company's independent auditor on design and compliance test of the company's internal controls relating to ceded reinsurance (See SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at 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. 2, paragraphs 10–13). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.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.

³ See footnote 2

- 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.
- 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 examination. Guidance on the auditor's considerations in those circumstances is provided in SAS No. 1, section 543, "Part of Examination Made by Other Independent Auditors."

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 examinations made in accordance with generally accepted auditing standards for periods ending on or after December 31, 1983. Earlier application is encouraged.

Reinsurance Auditing and Accounting Task Force

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➡ The next page is 30,339. ⬅

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 accounting controls regarding reinsurance maintained by the ceding company or by the assuming company.

.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 ced-

ing 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.¹

.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, paragraph 44. Paragraph 40 of FASB Statement No. 60 states—

¹FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, specifies certain accounting and disclosure requirements for reinsurance.

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.

Scope

.13 The following sections describe certain significant aspects of internal accounting control regarding ceded reinsurance and assumed reinsurance and describe the related auditing procedures. SAS No. 1, section 320.31, states that “the establishment and maintenance of a system of internal accounting control is an important responsibility of management.” The concept of reasonable assurance is inherent in management’s determination of the nature and extent of internal accounting controls, and the elements of audit risk and materiality underlie the application of generally accepted auditing standards by the independent auditor.

Ceded Reinsurance

Internal Controls of the Ceding Company

.14 The ceding company should have those internal accounting control 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 include²—

²The absence of one or more specific control procedures does not necessarily indicate a weakness in internal accounting control. SAS No. 1, section 320.55 (as amended) states that “the absence or the inadequacy of one specific control procedure designed to prevent or detect a particular type of error or irregularity may not be a weakness if other specific control procedures achieve the same purpose.”

- 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 adequacy of internal accounting controls 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.

.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 study and evaluation of the ceding company's internal accounting controls 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.

.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 system of internal accounting control.³ If the auditor decides not to rely on the company's control procedures, 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 accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 2, paragraphs 10 through 13). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.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 cir-

³SAS No. 1, section 320, states that "a material weakness is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions" (as amended by SAS No. 30). SAS No. 20 requires the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that the auditor becomes aware of through his examination.

cumstances, 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 Controls of the Assuming Company

.20 A significant element of the assuming company's system of internal accounting control 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 pro-

cedures 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 include⁴—

- 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, *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.

.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.

⁴See note 2.

- 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 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 accounting controls 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.

Auditing Procedures

.22 The independent auditor's study and evaluation of the assuming company's internal accounting controls 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.

.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 system of internal accounting control.⁵ If the auditor decides not to rely on the company's control procedures, 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 audi-

⁵See note 3.

tor'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)
- c. Performing auditing procedures at the ceding company or requesting the independent auditor of the ceding company to perform agreed-upon procedures
- d. Obtaining a special-purpose report from the ceding company's independent auditor on design and compliance tests of the company's internal controls relating to ceded reinsurance (see SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at 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. 2, paragraphs 10 through 13). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.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 examinations made in accordance with generally accepted auditing standards for periods ending on or after December 31, 1985. Earlier application is encouraged.

Reinsurance Auditing and Accounting Task Force

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