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# AICPA TECHNICAL PRACTICE AIDS

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TECHNICAL INFORMATION SERVICE  
INQUIRIES AND REPLIES

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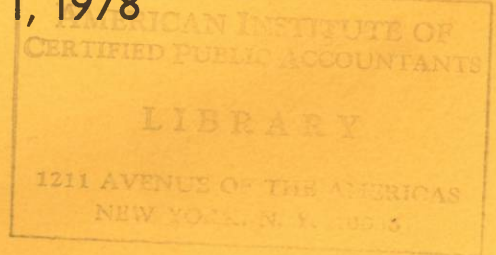
STATEMENTS OF POSITION  
OF THE  
ACCOUNTING STANDARDS DIVISION

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QUALITY CONTROL

AS OF JULY 1, 1978

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA TECHNICAL PRACTICE AIDS



# **AICPA TECHNICAL PRACTICE AIDS**

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**TECHNICAL INFORMATION SERVICE  
INQUIRIES AND REPLIES**

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**STATEMENTS OF POSITION  
OF THE  
ACCOUNTING STANDARDS DIVISION**

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**QUALITY CONTROL**

**AS OF JULY 1, 1978**

*Published for the*  
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# 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 of the American Institute of Certified Public Accountants, and guidance material related to the Voluntary Quality Control Review Program for CPA Firms.

## How This Volume is Arranged . . .

The contents of this Volume are arranged as follows :

### Technical Information Service Inquiries and Replies

- Introduction
- Financial Statement Presentation
- Assets
- Liabilities and Deferred Credits
- Capital
- Revenue and Expense
- Specialized Industry Problems
- Specialized Organizational Problems
- Audit Field Work
- Auditors' Reports

### Accounting

- Introduction
- Statements of Position

### Quality Control Review Program

## 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, and the Financial Accounting Standards Board 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 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 facilitates reference to the Statements. This index is arranged alphabetically by subject, with references to section and paragraph numbers.

The quality control review program includes checklist questionnaires for technical standards reviews of audited and unaudited statement engagements, and sample quality control documents for local CPA firms.

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# TECHNICAL INFORMATION SERVICE INQUIRIES AND REPLIES

## Introduction

The inquiries and replies in this section of the AICPA TECHNICAL PRACTICE AIDS are based on selected Technical Information Service correspondence.

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.

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 correspondence 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.





## TIS Section 1000

# FINANCIAL STATEMENT PRESENTATION

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**➡ 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*—Paragraph 2 of chapter 2A of Accounting Research Bulletin No. 43 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.

Statement on Auditing Standards 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.

Paragraph 13 of SAS No. 2 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 Noncurrent**

*Inquiry*—The statement of financial position of a securities broker has no breakdown between current and noncurrent assets and liabilities. Is this acceptable?

*Reply*—In most cases, it is not necessary that the assets and liabilities of a securities broker be classified as current or noncurrent. The AICPA Industry Audit Guide, *Audits of Brokers and Dealers in Securities* (1973), discusses this topic on page 54:

It should be noted that in Exhibits E and K [in the guide] no separation of assets and liabilities as between current and noncurrent is made. For the typical brokerage concern, such a distinction has little meaning and requires arbitrary decisions which might be misleading. For example, margin debit balances while subject to demand for payment by the broker, and thus theoretically current, are



generally sought to be maintained (as long as properly margined) on a long term basis. Similarly, bank loans, payable on demand, are usually collateralized by securities purchased in margin accounts by customers and may be virtually long term in substance. Investments in marketable securities may be long or short term but the factors influencing the sell or hold decision, such as alternative investment opportunities, change frequently. Some confusion as to current or noncurrent status could result also from the customary application of the net capital rules where concepts such as "immediate convertibility into cash," "collectible within 30 or 45 days," etc., have evolved.

Thus, for the typical brokerage concern, it is believed that appropriate description of the assets (such as distinguishing clearly between marketable and not readily marketable investments) and liabilities without arbitrary distinction between current and noncurrent is the most meaningful presentation. However, if the brokerage concern diversifies to a substantial degree into nonfinancial businesses, such a distinction may be appropriate.

### **.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.

### **.04   Offsetting of Long-term Contract Excess Billings       Against Excess Costs**

*Inquiry*—Billings in excess of costs exceed costs in excess of billings in connection with long-term contracts. Can these items be offset on the balance sheet?

*Reply*—Accounting Principles Board Statement No. 4 states in paragraph 198, item R-8B, "Assets and liabilities in the balance sheet should not be offset unless a legal right of setoff exists." Offsetting or netting amounts is also discussed on pages 31-33 of the AICPA Industry Audit Guide *Audits of Construction Contractors* (1965).

Billings in excess of costs and costs in excess of billings should be classified separately unless, in fact, a legal right of setoff exists. The presentation of "costs and estimated earnings in excess of billings on uncompleted contracts" and "billings in excess of costs and estimated earnings" is illustrated in the audit guide (pages 66-67).

#### **.05 Merchandise Held for Future Delivery Under Contract**

*Inquiry*—A meat packing company won a U.S. Department of Agriculture contract. Under the terms of the contract, the company must immediately buy and process beef carcasses. After inspection, the finished product will be transferred to a warehouse where it will be held for later delivery. During the storage period, the meat packer is not allowed to replace these products with other newly manufactured products. The risk of loss remains with the company.

Since the merchandise does not represent normal inventory, would it be proper to show this merchandise under the designation "unbilled government contracts"?

*Reply*—Under the circumstances, it would be acceptable to report this merchandise as "unbilled government contracts" since the meat is not available for normal sales and is being held pending instructions from the government.

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

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

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

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➡➡➡ *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 such title to the car buyer. Company A warrants main engine components for thirty days after date of sale.

The following income statement presentations of revenue are being considered:

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

What is the proper income statement 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 any deduction therefrom, the amount of sales, as follows:

Sales Arranged .....	\$300,000
Commissions Earned .....	<u>\$ 20,000</u>
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 Accounting Principles Board Opinion No. 30, paragraph 8?

*Reply*—Disposal of this subsidiary would constitute the disposal of a segment of a business as defined in paragraph 13 of APB Opinion No. 30 and also as discussed in the examples of disposal of a segment in Interpretation 1 to APB Opinion No.

30. Therefore, the income statement presentation 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.

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➡ *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*—Accounting Principles Board Opinion No. 19, in paragraph No. 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
Application of Funds: .....	—	(xx)
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*—Paragraph 10 of Accounting Principles Board Opinion No. 19 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*—Paragraph 7 of Accounting Principles Board Opinion No. 19 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? If so, what is the reasoning for excluding nonprofit organizations from this requirement?

*Reply*—Paragraph 5 to the Introduction to Accounting Research Bulletin No. 43 states in part:

The committee has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational, and similar nonprofit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a specific statement of a different intent by the company, its opinions and recommendations are directed primarily to business enterprises organized for profit.

In the absence of paragraph 7 to APB Opinion No. 19, statements of changes in financial position probably would have been required only for those nonprofit institutions for which the problems of presentation of financial statements did not differ materially from those of institutions organized for profit. Therefore, the import of paragraph 7 of APB Opinion No. 19 expresses a conclusion of the Board that reporting problems of nonprofit institutions in this matter generally will differ from those of profit-oriented institutions. If a nonprofit institution wishes to include such a statement, an auditor may of course express an opinion on financial statements which include a statement of changes in financial position.

#### **.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*—Accounting Principles Board 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
Working capital provided by operations....	<u>700,000</u>
Cumulative effect of change in depreciation method:	
Increase in retained earnings.....	\$100,000
Less: increase in equipment.....	<u>100,000</u>
Total funds provided during year .....	<u><u>\$700,000</u></u>

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 paragraph 14 of Accounting Principles Board Opinion No. 19. Paragraph 14 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.

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➤➤➤➤ *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.

Paragraph 6 of Accounting Research Bulletin No. 51 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.

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 consolidated statements are prepared?

*Reply*—Paragraph 6 of Accounting Research Bulletin No. 51 requires elimination of intercompany profits in preparation of consolidated statements. Paragraph 19a of Accounting Principles Board Opinion No. 18 similarly requires elimination of intercompany profits and losses of companies being reported on the equity basis. Profits on sales of receivables should not be exempted from these requirements.

#### **.11 Reasonableness of Rate of Return on Intercompany Profits of Public Utility**

*Inquiry*—A client is a public utility holding company with several affiliates. Paragraph 6 of Accounting Research Bulletin No. 51 has generally been interpreted to mean that intercompany profits on assets and services acquired from affiliates need not be

eliminated if they are not in excess of a reasonable rate of return on investment ordinarily capitalized. What is a reasonable rate of return? Is it the rate of return the Public Utilities Commission would allow the affiliated utility which is buying the service and assets?

*Reply*—ARB No. 51, paragraph 6 states:

However, in a regulated industry where a parent or subsidiary manufactures or constructs facilities for other companies in the consolidated group, the foregoing is not intended to require the elimination of intercompany profit to the extent that such profit is substantially equivalent to a reasonable return on investment ordinarily capitalized in accordance with the established practice of the industry.

A reasonable rate of return would be at least equivalent to the rate of return which the Public Utilities Commission would allow the utility on its rate base.

### **.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 should 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 Accounting Principles Board Opinion No. 18 would be appropriate. Refer also to the Interpretation

No. 2, Investments in Partnerships and Ventures to APB Opinion No. 18.

**.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. Paragraph 14 of Accounting Principles Board Opinion No. 18 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

➡ *The next page is 269.* ←



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*—Accounting Research Bulletin 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.

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➡ 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.

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➤ *The next page is 451.* ➤





## Section 1600

# Personal Financial Statements

### .01 Personal Financial Statements on Cash Basis

**Inquiry**—The AICPA Industry Audit Guide, *Audits of Personal Financial Statements*, states that accrual accounting should be used. An individual has investments in proprietorships, partnerships, and corporations whose books are kept on the cash basis. Should the financial statements of these entities be converted to the accrual basis for use in the preparation of the personal financial statements?

**Reply**—If the statement of a proprietorship, partnership, or corporation included in a personal financial statement represents financial statements prepared on the cash basis and it differs materially from statements that would have been prepared on the basis of generally accepted accounting principles, the auditor should take exception or give an adverse opinion, depending upon the materiality of the differences involved. If the auditor cannot determine the amount of the investment under generally accepted accounting principles and he believes the difference might be material, he should either issue a qualified (“subject to”) opinion or disclaim an opinion, depending upon his belief as to the materiality of the differences.

### .02 Equity Method for Investments on Personal Financial Statements

**Inquiry**—Is it permissible to use the equity method of accounting for investments in the stock of corporations that are included in a personal statement of assets and liabilities?

**Reply**—Paragraph 2 of Accounting Principles Board Opinion No. 18 indicates that it does not apply to nonbusiness entities such as estates, trusts and individuals.

The AICPA Industry Audit Guide, *Audits of Personal Financial Statements* (1968), states on page 6, however, that:

Business interests, such as sole proprietorships, partnerships, joint ventures and corporations taxed under Subchapter S of the Internal Revenue Code, should be presented in the cost basis column at cost adjusted for any accumulated undistributed earnings or losses since acquisition.

Pages 21-25 of the Audit Guide give an example of personal financial statements which include an account in the asset section of the statement of assets and liabilities titled, "Interest in net assets of XYZ Corp." Both the cost and estimated value basis for this interest is shown. [Amended]

### **.03 Deferred Taxes on Undistributed Earnings on Personal Financial Statements**

*Inquiry*—Accounting Principles Board Opinion No. 24 discusses the treatment of tax effects of differences between taxable income and pretax accounting income attributable to an investor's share of earnings of investee companies accounted for by the equity method. Does APB Opinion No. 24 apply to personal financial statements wherein an individual's equity in a corporation must be adjusted to recognize deferred taxes on undistributed earnings?

*Reply*—APB Opinion No. 24 deals with accounting for income taxes in connection with investments in common stock accounted for by the equity method (other than subsidiaries and corporate joint ventures) and relates to Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. An investor is defined in paragraph 3 of APB Opinion No. 18 as "a business entity that holds an investment in voting stock of another company." Even though the individual would be considered an investor in the normal sense, an individual would not be considered an investor as defined in APB Opinion No. 18 since the individual would not be considered a business entity. Therefore, the provisions of APB Opinion No. 24 relating to accounting for the tax effects of undistributed earnings of investees would not apply to individuals and would not be applicable in preparing personal financial statements.

### **.04 Valuation of Community Property After Probate**

*Inquiry*—A client and his wife held community property, and at the wife's death, this community property was required by the state to be probated. The entire property proceeded through probate and was "fully controlled" by the estate at this time. At the time of distribution of the assets controlled by the estate, one half of the property representing the wife's share went into a trust as provided by the will, and the remaining half of the property was distributed back to the husband.

What is the cost basis of the surviving spouse's share of the community property? Is it one half of the original cost or one half of the value of the estate at the time of the wife's death?

*Reply*—There is a discussion on page 6 of *Audits of Personal Financial Statements*, an AICPA Industry Audit Guide, of the cost basis in connection with personal financial statements. Based on this, because the widower's ownership was not acquired by inheritance from his wife, the proper basis of the property should be his cost prior to the wife's death. However, the Audit Guide also states that disclosure of the estimated values of the property should be included in the financial statements.

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## TIS Section 2000

**ASSETS**

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**➡ 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.

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➤→ *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 probably also be presented in the financial statements at their fair value at the statement date, and cost should be disclosed parenthetically or by footnote.

The net increase or decrease during the year in unrealized appreciation or depreciation of investments would be reported as a separate caption apart from realized gains and losses 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.

## **.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 of Financial Accounting Standards No. 12 covers the accounting for certain marketable securities and specifies in paragraph 12 disclosures in financial statements or accompanying notes.

Paragraphs 4 and 9 of Chapter 3A of Accounting Research Bulletin No. 43 apply to the reporting of other temporary investments (commercial paper, certificates of deposit, and marketable securities not covered by Statement 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.

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## 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*—SEC Accounting Series Release No. 102, “Balance Sheet Classification of Deferred Income Taxes Arising from Installment Sales,” and paragraph 57 of APB Opinion No. 11 describe the handling of the deferred tax liabilities related to installment sales. Accounting Research Bulletin 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.” Accordingly, if a corporation is classifying its installment notes receivable as current on the theory that they conform generally to normal trade practices and terms within the business, it therefore follows that the applicable deferred income tax liabilities should also be classified as current.

#### **.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 Sold**

*Inquiry*—On the last day of its fiscal year, Corporation A sold its accounts receivable at 100% of face amount to a commercial bank which held back 10% of the face amount of receivables sold. The sale 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 sale, 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 sale of receivables be presented and disclosed in the financial statements of Corporation A?

*Reply*—Statement of Position 74-6,\* *Recognition of Profit on Sales of Receivables With Recourse*, AICPA Accounting Standards Division, June 14, 1974 [section 10,010] discusses accounting for the sale of receivables. Footnote 1 on page 1 of the Statement of Position [section 10,010.01] indicates that the term “recourse” would also apply to agreements where the seller guarantees the buyer a “yield.” Paragraph 15 on page 9 [section 10,010.15] indicates that the buyer’s security in recourse transactions is often in the form of so-called “dealers’ reserves” or “holdbacks.” Based on these two references, the receivables sold by Corporation A should be treated as receivables sold with recourse for purposes of financial reporting.

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\* See page 16,551 in this Volume.

The profit should be accounted for by the delayed recognition method, which is the method recommended by the Accounting Standards Division. A discussion of the application of the delayed recognition method begins on page 25 of the Statement of Position [section 10,010.43]. Footnote 5 on page 25 [section 10,010.44] indicates that differences arising between financial accounting for recognition of profit or loss on sales of receivables and income tax accounting for such profit or loss should be treated as timing differences in accordance with Accounting Principles Board Opinion No. 11. Therefore, if there is a difference between the installment basis for tax purposes and the delayed recognition method, the timing difference provisions of APB Opinion No. 11 (including disclosure requirements) should be followed.

Recommended disclosures for the sale of receivables with recourse are discussed in paragraphs 48 and 49 of the Statement of Position [sections 10,010.48 and 10,010.49]. Disclosure should include:

- Nature and amount of receivables sold during each period
- Payment terms
- Amount of receivables outstanding at date of the latest balance sheet presented
- Terms of agreements
- Amount of funds in “dealers’ reserves” at latest balance sheet date
- Company’s accounting policy for profit or loss on sale of receivables with recourse
- Amount of differential included in each period for which an income statement is presented and amount deferred at date of latest balance sheet presented.

Although the accounts receivable were sold on the last day of Corporation A’s fiscal year, the tax effect still relates to the receivables sold in the current fiscal year. Therefore, this change in reporting for tax purposes should be mentioned in the current year’s financial statements.

#### **.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.

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## 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.

**.07 Inventory of Nursery of Ornamental Plants and Christmas Trees**

*Inquiry*—A nursery has two branches, one of which is in Vermont and the other in Connecticut. In Vermont, balsam Christmas trees are grown from seedling stock. In Connecticut, plants, shrubs, and flowers are purchased for retail and about 90% of these purchases are sold during the growing season. The other 10% are put back into the ground in the fall and remain there until the next season, or until someone purchases them. In the case of some shrubs they may remain in the ground for a number of years. Some of these shrubs which have been “lined in” die, and some eventually grow too large to be used for ornamental purposes and have to be dug up and destroyed.

How shall the stock of Christmas trees be valued? Also, how can the inventory value of the plants and shrubs left over at year end be determined?

*Reply*—A proper accounting treatment for the Christmas trees growing in Vermont is to capitalize the cost of seedlings, planting, cultivating, etc., and take depletion at the time the trees are cut and sold. However, for purposes of properly computing the depletion attaching to trees severed (or for that matter, writing off the cost attaching to any significant numbers of trees which upon a cruise of the area, are observed to have died or otherwise lost their useful value), records of the number of seedlings planted in designated rows, lots, or sectors should be maintained.

As to the question regarding purchased shrubs and plants left over at the end of the growing season, some method of inventory must be adopted so that there can be a fair reflection of gross income. Perhaps a periodic inventory could be taken at the end of the financial period. If an expert nurseryman were to accompany the accountant around the area where these plants are set, he could determine the number and grade of plants not sold. An “average” price per plant could be taken from the purchase invoices. To this should be added the labor and other costs of lining them back into the ground. The average cost applicable to those

plants which later die or are destroyed, should, of course, be written off.

The foregoing assumes that the shrubs left over at the end of the growing season do not, for the most part, represent inferior stock resulting from customers' culling of the best stock during the active season. If their eventual marketability is dubious, then they should be carried forward in inventory only at their estimated net realizable value or recoverable portion of actual average cost.

#### **.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.

Accounting Research Bulletin 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.

#### **.10 Change in Method of Pricing New Car Inventory**

*Inquiry*—An automobile dealer wants to change from the specific identification method of pricing new car inventory to LIFO. Is LIFO an acceptable method of pricing new car inventory?

*Reply*—While the specific identification method seems preferable for pricing new car inventory, LIFO would be acceptable. Justification for the change should be given.

Paragraphs 16 and 17 of Accounting Principles Board Opinion No. 20 state in part:

16. The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable. . . .

17. The nature of and justification for a change in accounting principle and its effect on income should be disclosed in the financial statements of the period in which the change is made. The justification for the change should explain clearly why the newly adopted accounting principle is preferable.

Paragraph 5 of FASB Interpretation No. 1 states:

5. A change in composition of the elements of cost included in inventory is an accounting change. A company which makes such a change for financial reporting shall conform to the requirements of APB Opinion No. 20, including justifying the change on the basis of preferability as specified by paragraph

16 of APB Opinion No. 20. In applying APB Opinion No. 20, preferability among accounting principles shall be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone.

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»»→ *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*—Paragraph 22 of APB Opinion No. 17 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 maintaining 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*—Paragraph 159 of Accounting Principles Board Statement No. 4 states, "If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect."

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.

#### **.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. Page 5 of the AICPA Industry Guide, *Hospital Audit Guide*, 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.

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➡ *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 in the construction industry has entered into a joint venture with other contractors. 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*—AICPA Industry Audit Guide *Audits of Construction Contractors* (1965) states on page 36:

The contractor’s share of joint venture earnings should be shown separately in the income statement of the contractor. It is not common to record the proportionate share of billings and costs applicable to joint venture operations in the financial statements of individual members.

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 "it is not common" and "should ordinarily" contained in the above references indicate 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.

**.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 this investment on the equity basis. The hedge fund is permitted to record the unrealized appreciation of its investments according to generally accepted accounting principles, but is it permissible for the client to include, on its income statement and balance sheet, its pro rata share of the increases in hedge fund assets due to unrealized appreciation?

*Reply*—While the "hedge fund" is permitted to record unrealized appreciation, the investor should pick up its share of the income for the year on a realized basis. Of course any unrealized losses which reflect permanent decreases in values should be recognized. Therefore, in picking up its 40% interest in the hedge fund, the client should adjust the net income reported by the hedge fund for the increases and decreases in unrealized appreciation.

**.07 Equity Method for Small Business Investment Companies**

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

*Reply*—Paragraph 2 of Accounting Principles Board Opinion No. 18 states in part:

This Opinion does not apply to investments in common stock held by . . . investment companies registered under the Investment Company Act of 1940 or investment companies which would be included under the Act (including small business investment companies) except that the number of stockholders is limited and the securities are not offered publicly. . .

This exclusion was intended to include all investment companies whose exemption from registration under the Investment Company Act was based either upon limited number of stock-

holders or upon the issuance of securities that were not required to be registered with the SEC because of limited size of the offering or limitations upon the purchasers. Therefore, the investments of a small business investment company may be carried at cost to the investor that is not in excess of the present fair value of the investment.

**.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 Accounting Series Release No. 113 of the Securities and Exchange Commission issued October 21, 1969.

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.

The Interpretation 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 the Interpretation, 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.

Section 332.05 of *Statement on Auditing Standards No. 1* 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 . . .

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➡ *The next page is 1391.* ←



## Section 2240

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

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

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

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

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

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

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

Note 3 to paragraph 7 of this Chapter states:

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

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

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

Therefore, if a company takes out policy loans from the insurance company on life insurance policies which it owns and if there is no intention to repay the loan during the ensuing 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.

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➡ *The next page is 1451.* ←

## Section 2250

### *Intangible Assets*

#### **.01 Presentation of Intangible Contracts with Licensees**

*Inquiry*—A company performs services for its customers through licensee-licensor relationships with local franchises. Through the agreement with licensees, the client agrees to repurchase any licensee's clients at an established value.

How should the costs of contracts acquired by repurchase be shown in the accounting records and financial statements?

*Reply*—Paragraph 24 of Accounting Principles Board Opinion No. 17 states:

The Board concludes that a company should record as assets the costs of intangible assets acquired from other enterprises or individuals. Costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred.

Therefore, the only amount which could be entered in the financial statements would be the cost of client contracts acquired by repurchase. Such costs of contracts acquired subsequent to October 31, 1970 should be amortized over a period of not more than forty years in accordance with paragraphs 28 and 29 of APB Opinion No. 17. Amortization of such costs which were on the books as of October 31, 1970 is encouraged, but not mandatory.

#### **.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.

**.03 Amortization of Franchise Rights of Regulated Freight Carrier**

*Inquiry*—Accounting Principles Board Opinion No. 17 states in paragraph 27, “The value of intangible assets at any one date eventually disappears and . . . the recorded costs of intangible assets should be amortized by systematic charges to income over periods estimated to be benefited.”

A client is an interstate regulated freight carrier and has certain franchise rights granted by the Interstate Commerce Commission. The value of these rights do not disappear but can actually increase in value. Even in an unsuccessful operation, the rights can be worth more than their original cost. The value of these rights does not become zero unless the rights are revoked by the ICC.

APB Opinion No. 17 states in paragraph 32, “Ordinarily goodwill and similar intangible assets cannot be disposed of apart from the enterprise as a whole.” This also is not true of these franchise rights which are readily marketable.

Is it, then, sound accounting policy to amortize these perpetual franchise rights?

*Reply*—Intangible assets such as franchise rights come under the provisions of paragraph 29 of APB Opinion No. 17. As indicated there, the lives of some intangible assets may be indeterminate but are likely to exceed forty years. The Opinion provides that in such cases the amortization of the intangible asset should be made over a maximum of forty years and not an arbitrary shorter period. The argument that the value of the franchise rights does not decrease and may in fact increase appears to overlook the objective of amortization. The objective of amortization is not an attempt to account for “value” but rather to “allocate” cost.

The argument that the franchise rights granted to a particular carrier are perpetual includes the comment that the Interstate Commerce Commission can withdraw the franchise, and regulatory agencies do occasionally revoke “perpetual” franchises. In summary, such rights effectively have an indeterminate life and should be amortized over the maximum period provided for in Opinion No. 17.

**.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*—Paragraph 17 of Accounting Principles Board Opinion No. 6 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.” Paragraph 25 of APB Opinion No. 17 states in part, “Intangible assets acquired singly should be recorded at cost at date of acquisition.” A similar statement appears in paragraph 4 of Chapter 5, ARB No. 43, which Opinion No. 17 superseded.

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.

#### **.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 paragraph 23(a) of APB Opinion No. 30, 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 paragraph 26 of Accounting Principles Board 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 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 state-



ments. 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.

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## TIS Section 3000

# LIABILITIES AND DEFERRED CREDITS

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## 3600 Deferred Credits

- .01 Balance Sheet Presentation of Unearned Revenue
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➡ 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.

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➡ 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 paragraph 31 of Accounting Principles Board Opinion No. 17 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 Financial Accounting Standards Board Statement No. 4 which deal with early extinguishment of debt. [Amended]

**.07 Calculation of Present Value of an Annuity**

*Inquiry*—Exhibit B on page 25 of the AICPA Industry Accounting Guide, *Accounting for Profit Recognition on Sales of Real Estate* (1973), 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 x 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 . . . . .	\$204,102.48	
Rounded as per Guide . . . . .	\$204,000.00	

The present value factor is 127.9071. The factor is for 335 periods at an interest rate of 17/24% per period ( $8\frac{1}{2}\%$  per year divided by twelve months per year equals 17/24% per month).

Perhaps the example shown in the Accounting Guide would be clearer if it was shown as:

$$(\$1,583.33 \text{ plus } [\$1,583.33 \times 127.9071])$$

#### **.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.

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➡ The next page is 2471. ←



## Section 3400

### ***Contingent Liabilities***

#### **.01 Contested Liability**

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

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

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

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

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➡ *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]

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➡ The next page is 2671. ←



## Section 3600

### *Deferred Credits*

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

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

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

*Reply*—Paragraph 153 of Statement No. 4 of the Accounting Principles Board indicates that amounts received for goods or services in advance are not treated as revenue of the period in which they are received but as revenue of the period or periods in which they are earned. These amounts are carried as "unearned revenue"—that is, liabilities to transfer goods or render services in the future—until the earning process is complete. Therefore, the unearned portions of the insurance premiums and membership dues represent liabilities to provide services in the future. While the description of the liabilities might vary, to present the unearned premiums and membership dues outside of the liability section of the balance sheet would be inappropriate.

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**TIS Section 4000****CAPITAL**

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➡➡➡ *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 paragraph 20 of APB Opinion No. 30. 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 paragraph 26 of APB Opinion No. 30. [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*—Yes, but some state statutes require that stock be issued for cash, property, or actual services rendered. Therefore, if there is such a state restriction, the issuance of the stock should be recorded on the books of the company as a charge to capital stock discount and a credit to capital stock.

A note to the financial statements should describe the circumstances under which the restricted stock was issued with a brief description of the restrictions.

#### **.06 Stock Issued to Landlord**

*Inquiry*—A landlord agreed, in an arm’s-length transaction, to reduce the annual rent for the first year of a ten year lease in return for a tenant corporation’s promise to sell a certain number of shares of its capital stock to the landlord at an agreed upon price per share. These shares would be part of an initial

public offering (at the same per share price), and, if the public offering was not consummated, the agreement to reduce the rent would be of no force and effect.

How should the tenant corporation record this transaction?

*Reply*—The proceeds from stock sold to the landlord amount to the per share purchase price plus the value of the rent reduction. Any proceeds beyond the stated value of the capital stock should be credited to an additional paid-in capital account.

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➡ *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.

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➡ *The next page is 3201.* ←





## Section 4130

### Warrants

#### .01 Accounting for Debt With Restricted Warrants

*Inquiry*—A corporation issued senior notes payable under an agreement with an institutional lender. In connection with the issue of the notes, the corporation granted the lender ten-year warrants to purchase shares of common stock at \$10 per share payable either in cash or through surrendering to the corporation the senior notes having the principal amount required to be paid. The price of \$10 per share, is identical with the price per share at the time of the corporation's latest issue of shares to the public, and lower than the quoted market price at the time of issue of warrants.

By the terms of the applicable agreement, the warrants for purchase of the corporation's common stock cannot be exercised at all for the first two years, and only partially exercisable in the following years. How should this transaction be treated on the corporation's records?

*Reply*—A separate value should be assigned to the warrants issued with notes payable, even though there are restrictions upon their exercisability. Accounting Principles Board Opinion No. 14 does not discuss warrants issued with restricted features. However, paragraph 18 points out that it is not practicable to discuss all possible types of debt issued with stock purchase warrants or conversion features, or a combination thereof, and those securities not specifically discussed should be dealt with in accordance with the substance of the transaction.

#### .02 Warrants Issued With Debentures and Common Stock

*Inquiry*—A client is offering, as a unit, subordinated convertible debentures, shares of common stock, and warrants.

Is an allocation to paid-in capital necessary because the warrants are being offered as part of the issue?

*Reply*—There should be an allocation to paid-in capital for that portion of the proceeds of the debenture issue attributable to the detachable stock warrants in accordance with paragraph 16 of Accounting Principles Board Opinion No. 14. A simple

statement describing the allocation of registration expenses and the allocation to paid-in capital would be in order.

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➡ *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 Accounting Principles Board Opinion No. 25?

*Reply*—Paragraph 20 of APB Opinion No. 25 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*—Paragraph 12 of Accounting Research Bulletin No. 43, Chapter 13B, 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." 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 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.

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➤➤➤ *The next page is 3341.* ←←←

**Section 4150****Stock Dividends and  
Stock Splits****.01 Stock Dividends of Closely-Held Corporation**

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

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

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

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

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➤ *The next page is 3401.* ←



## Section 4160

### ***Contributed Capital***

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

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

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

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➡ *The next page is 3551.* ←



## Section 4210

### Dividends

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

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

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

#### .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.

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➡ *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*—Accounting Series Release No. 25 of the Securities and Exchange Commission includes the following definition of a quasi-reorganization:

The term quasi-reorganization has come to be applied in accounting to the corporate procedure 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 release 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:

- (4) 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." This statement expressly supersedes paragraph 2 of Chapter 7A, Accounting Research Bulletin No. 43 which states, "This section does not deal with the *general* question of quasi-reorganizations, but *only* with cases in which the exception permitted under the rule of 1934 is availed of by a corporation." (Italics supplied.)

Thus, the official statements of the Securities and Exchange Commission and of the Accounting Principles Board can be interpreted as indicating that a quasi-reorganization, if otherwise appropriate, could result in a write-up as well as a write-down of assets. [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 its Accounting Series Release No. 25, 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]

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➡ 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 should prepare a carryforward workpaper schedule which indicates the original invested capital and subsequent transfers from retained earnings. [Amended]

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## TIS Section 5000

# REVENUE AND EXPENSE

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➡ *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*—Paragraph 151 of Accounting Principles Board Statement No. 4 states:

The exchange required by the realization principle determines both the time at which to recognize revenue and the amount at which to record it. Revenue from sales of products is recognized under this principle at the date of sale, usually interpreted to mean the date of delivery to customers. Revenue from services rendered is recognized under this principle when services have been performed and are billable. Revenue from permitting others to use enterprise resources, such as interest, rent, and royalties is also governed by the realization principle. Revenue of this type is recognized as time passes or as the resources are used. Revenue from sales of assets other than products is recognized at the date of sale. Revenue recognized under the realization principle is recorded at the amount received or expected to be received.

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.

#### **.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 amount 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.

#### **.12 Prepaid Interest Received on Real Estate Transaction**

*Inquiry*—A seller of real estate obligates himself to obtain financing and, in turn, as part of the sale, receives a note receivable, a loan fee, and prepaid interest for a fifteen-month period

from the date of sale. The specifics of the transaction support recognition of a sale as outlined in the AICPA Industry Accounting Guide *Accounting for Profit Recognition on Sales of Real Estate* (1973).

The loan fee will be recognized as income currently. Should the fifteen months' interest received be recognized in the current period, or should only that portion actually earned currently be recognized, deferring the remainder? The interest incurred during construction, which the seller has elected to capitalize as part of the cost of construction (for tax purposes), would be offset against that portion of prepaid interest earned during the same period.

*Reply*—Accounting Principles Board Statement No. 4, paragraphs 148 through 153, discuss the revenue realization principle. Based on this, the loan fee should be recorded as income, and the prepaid portion of the interest received should be deferred until earned. The interest capitalized during construction could be “offset” (charged as an expense) against that portion of the prepaid interest earned during the same period, but it would also be acceptable to capitalize the interest cost for financial statement purposes.

### **.13 Accounting for Mortgage “Points”**

*Inquiry*—What is the proper method of accounting for fees collected as “points” on new loans?

*Reply*—The portion of the fees collected as “points” which are necessary to cover the cost of writing the mortgage may be taken into income in the period in which these costs are incurred. “Points” representing an adjustment of the interest rate should be deferred and amortized over the life of the loan. Some states have specific regulations covering the treatment of points, and therefore, the auditor should request that the client have his legal counsel determine the effects of any state regulations to which they may be subject.

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

*Inquiry*—A client is in the business of bringing lenders and borrowers together for a fee. When a construction mortgage has been arranged and agreed to, it would appear that the client has earned its fee. However, because of the terms of the fee arrange-

ment, 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 paragraphs 148-153 of Accounting Principles Board Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*. Paragraph 150 states in part:

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.

Paragraph 150 goes on to say that "revenue from services rendered is recognized under this principle when services have been performed and are billable."

Applying the above comments 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*—Paragraph 148 of Accounting Principles Board Statement No. 4 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.

**.18 Revenue Recognition for Short-Term Contracts**

*Inquiry*—A wholly owned subsidiary of a local newspaper prints booklets and other advertising material for inclusion generally as supplements in Sunday newspapers.

This company previously recorded income from sales when the entire order was shipped and billable. Orders in process which were partially completed at the end of a month were recorded in inventory at cost. Partial billings are not made, and the terms of the contracts do not permit them.

Under a new method, orders partially completed at the end of a month are being taken into income. The sales value is determined by multiplying the unit selling price per the signed contract times the number of books completed with the resulting receivable being set up as “unbilled receivables.” All of the accumulated costs are charged against cost of sales. The work in process inventory thus contains only material and labor costs on those jobs which have not yet gone to press. Is the above described change in accordance with generally accepted accounting principles?

*Reply*—In effect the company is now recognizing income on a percentage of completion basis. This method of accounting is appropriate for long-term contracts but not for short-term contracts. Accordingly, the company should not report income for those orders partially completed at the end of a month but should follow the conventional accrual method of reporting income.

**.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 Accounting Principles Board Statement No. 4, paragraphs 150-153. Revenue is generally recognized when the earnings process is complete or virtually complete and an exchange has taken place. Revenue from services is recognized when the services have been performed and are billable.

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 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*—The realization criteria in paragraph 150 of Accounting Principles Board Statement No. 4 state: “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.” 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.

**.26 Gain on Nonmonetary Exchange of Investments in Common Stocks**

*Inquiry*—Company B, which is 100% owned by Company A, exchanged its 100% investment in Company C for a 43% investment in Company D. Prior to the exchange, A held a 10% investment in D. The market value of D’s stock, which is traded publicly, was greater at the date of exchange than the carrying basis of B’s investment in C. Does the difference between the market value of D’s stock and the carrying basis of B’s investment in C represent a gain to be included in the determination of B’s net income for the period?

*Reply*—The exchange of C stock for D stock is a nonmonetary transaction. Paragraph 18 of Accounting Principles Board Opinion No. 29 states:

The Board concludes that in general accounting for non-monetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a non-monetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered.

Accordingly, the difference between the market value of D's stock and the carrying basis of B's investment in C represents a gain which should be included in B's income.

#### **.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*—Paragraphs 150-153 of Accounting Principles Board Statement No. 4 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.

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➡ *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.

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➡ The next page is 4201. ←

## Section 5220

### Interest Expense

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

*Inquiry*—A client experienced problems in meeting its current obligations and reached an agreement with its primary creditor concerning several mortgage loans. Under the agreement, the interest rate on these loans will, for the present, be reduced from 10% 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, 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.

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»»»→ *The next page is 4281.* ←«««





## Section 5230

### ***Pensions and Retirement 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 paragraph 27 of Accounting Principles Board Opinion No. 8?

***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. Interpretation No. 13 to APB Opinion No. 8 discusses actuarial gains and losses further.

#### **.04 Unrealized Appreciation of Pension Fund Investments—I**

***Inquiry***—A retirement plan wants to record a portion of its unrealized capital gains on securities. The main part of the unrealized gain to be recognized will be applied to increase the book value of securities (and, correspondingly, to decrease unfunded liability), and the remainder will be applied to the employer’s current cost requirement for the year.

Should the recognition of unrealized appreciation on securities, utilized by the actuaries in the actuarial assumption for computing current costs and for reducing the unfunded liability of the plan, be reflected in the financial statements of the retirement plan?

Also, if the unrealized appreciation on securities is reflected in the financial statements of the plan, what method would be

acceptable for adjusting realized gains which have been computed based on the actual cost of individual securities, without giving effect to the unrealized appreciation for each individual security? Is it necessary to revalue each security in the portfolio from the actual cost to actual cost plus the adjustment for unrealized appreciation so that the proper realized gains can be accounted for?

*Reply*—The answer to the first question is found in paragraph 32 of Accounting Principles Board Opinion No. 8 which states that the unrealized appreciation should be recognized in the accounts in the determination of the pension cost provision either in the actuarial assumption or as described in paragraph 30.

As to the second question, reference should be made to paragraphs 26-32 of APB Opinion No. 8. With the exception of debt securities mentioned in paragraph 32, both unrealized appreciation and unrealized depreciation should be calculated for each security in the portfolio and applied using one of the three methods mentioned in paragraph 26, i.e., a) immediate recognition, b) spreading, or c) averaging.

Pages 134-5 of Accounting Research Study No. 8, *Accounting for the Cost of Pension Plans*, contain a discussion of unrealized appreciation (depreciation) of pension fund investments.

**.05 Unrealized Appreciation of Pension Fund Investments—II**

*Inquiry*—A pension plan has unrealized capital gains on securities. Would disclosure in the notes to the financial statements of the effect of assuming the unrealized appreciation on securities be an acceptable alternative to the nonrecognition of unrealized appreciation in the balance sheet and income statement?

*Reply*—Disclosure in notes to the financial statements of the effect of the actuarial assumption on the unrealized appreciation on securities is not an acceptable alternative to the nonrecognition of unrealized appreciation in the financial statements.

**.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 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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➡➡➡ *The next page is 4381.* ←←←

**Section 5240****Cost Allocation****.01 Transfer Pricing Between Manufacturing Division and Selling Division**

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

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

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

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

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

Where intracompany transactions account for a large share of the divisions' 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 \$100,00 and costs of goods sold of \$70,000, since the intracompany sale will be eliminated in the consolidation.

## **.02 Costs of Research and Development Conducted for Others Under Contract**

*Inquiry*—Corporation A contracts to do research and development work for other organizations. The research and development work is done under jointly sponsored programs. Corporation A sells the results of its work (in the form of reports and computer programs) to other companies at a price which is only a fraction of the total cost but, when multiplied by the number of sales, represents a cumulative dollar income well in excess of the total cost. History has shown that sales representing about 50 percent of the total estimated sales usually occur by the end of the year in which the program is completed. The remaining 50 percent usually occurs within three to five years after the completion of a program. Generally, the results of these programs have proved to be quite successful from both a financial and technical viewpoint.

May the costs of the jointly sponsored programs, which are in excess of revenues from the original sponsors but are recoverable from future sales, be considered as inventory; or should such excess costs be expensed?

*Reply*—The costs of such programs which are in excess of revenues from the original sponsors but are recoverable from future sales are properly accounted for as inventory.

## **.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 such 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 of Financial Accounting Standards No. 2 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 such costs because factory overhead is allocated to inventory.

However, paragraph 14 of FASB Statement No. 2 indicates that a government-regulated enterprise deferring research and development costs in accordance with the Addendum to APB Opinion No. 2 has certain additional disclosure requirements.

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➡ *The next page is 4411.* ←





## 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 Accounting Principles Board Opinion No. 11, 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."

#### .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 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 de-

ferred 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 Accounting Principles Board Opinion No. 11 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. . . . The current portions of such deferred charges and credits should be those amounts which relate to assets and liabilities classified as current.”

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.

### **.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.....	\$ (82,000)
Extraordinary items, net of applicable tax effect:	
Description of items (\$200,000 less tax effect of \$63,000).....	137,000
Net income .....	<u>\$ 55,000</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 paragraph 41 of Accounting Principles Board Opinion No. 11 and 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 are 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.

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➡ *The next page is 4501.* ←





## Section 5260

### ***Estimated Losses***

#### **.01 Recognition of Estimated Losses on Uncompleted Contracts**

*Inquiry*—An engineering firm manufactures and sells telemetry components on the basis of bids previously submitted to customers. In some cases, engineering time is required to modify a component to customer specifications. Since the amount of required engineering time is not known at the time a bid is submitted, costs to complete a particular job may exceed the bid price. The firm completes all jobs.

Presently all costs that accumulate on a particular job (direct materials, labor, and applied manufacturing and engineering overhead) are charged to that job and treated as work in process, even though the costs may exceed the selling price. Once the job is completed, it is taken out of work in process inventory and treated as costs of completion in the month that the job is shipped. Therefore, a loss on a job is recognized only when the job is shipped. When cost to complete a job is expected to exceed the bid price, what disclosure should be made on the balance sheet?

*Reply*—The problem faced by the firm is not primarily one of disclosure but rather that of satisfying the generally accepted accounting principle of “providing for losses which are reasonably certain to occur.”

It is assumed that the firm is accounting on the completed-contract basis. With regard to construction companies using this method of accounting, Accounting Research Bulletin No. 45, *Long-term Construction-type Contracts*, paragraph 11 states, “Although the completed-contract method does not permit the recording of any income prior to completion, provision should be made for expected losses in accordance with the well established practice of making provision for foreseeable losses.” The same concept applies to companies accounting under the percentage-of-completion method. (ibid., par. 6)

A possible journal entry to recognize the loss would be a charge to “Estimated Loss on Uncompleted Contracts” while crediting “Estimated Liability for Loss on Uncompleted Contracts.” This estimated liability could then be deducted from any

excess of accumulated costs over related billings (or added to any liability arising from billings in excess of accumulated costs) for balance sheet purposes. If the loss is not deductible for tax purposes, part of the income tax paid should be set up as a deferred charge.

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## Section 5290

### Other Expenses

#### .01 Income Statement Treatment of Royalty Payments

*Inquiry*—A company has a license agreement to manufacture an industrial machine which was designed by the licensor. The company must pay a royalty of 10% of all sales made to customers other than the licensor and their co-designer. All sales made to the licensor and the co-designer are quoted at a lower price which reflects the fact that royalties will not have to be paid on those sales. How should the royalty payments be treated on the income statement?

*Reply*—There are no specific pronouncements which indicate how royalty payments should be classified on the income statement. However, royalties should not be deducted from gross sales to arrive at net sales. Royalties are considerably different from sales discounts and allowances. The licensee usually bears the risk of collection and would have to pay the royalty whether or not the customer pays the licensee. In addition, the royalty payments would not represent a manufacturing cost which would become part of the cost of sales. Classifying royalty payments as a manufacturing cost would cause the balance sheet to reflect a liability which has not yet been incurred. Therefore, it would be appropriate to treat royalty payments as a selling expense in the income statement.

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➡ The next page is 4801. ←



## Section 5400

### *Extraordinary Items*

#### **.01 Loss on Abandonment of Sales Project**

*Inquiry*—A company is engaged primarily in commercial and agricultural land sales, but some retail land sales and condominium sales are also made. The company acquired a retail land sales project under an agreement stating that, if the company did not desire to pursue the project, the property would be returned with no liability to the company.

The company invested a considerable amount of money in the project, but because of the declining state of the economy, the company decided to return the project to the original owner before any sales had been made.

Does the abandonment of the project represent a disposal of a segment of the business, an unusual and nonrecurring extraordinary loss, or an ordinary loss?

*Reply*—Paragraph 13 of Accounting Principles Board Opinion No. 30 describes a segment of the business as “. . . a component of an entity whose activities represent a separate major line of business or class of customer.” Paragraph 20 of the Opinion sets forth the two criteria for classification of an event or transaction as an extraordinary item. Although the criterion of infrequency of occurrence is met, it does not appear that the unusual nature criterion, described as “the possession of a high degree of abnormality, and of a type clearly unrelated to, or only incidentally related, to the ordinary and typical activities of the entity,” portrays this transaction.

If the company's formal decision to disengage itself from retail land sales applies to its entire retail land sales operation, the write-off should be considered as part of the sale of a segment of a business, but the segment to be accounted for must be the whole retail land sales operation. Otherwise, the write-off should be accounted for in accordance with paragraph 26 of APB Opinion No. 30 as a material transaction that occurs infrequently, but does not meet the criterion for classification as unusual in nature.

#### **.02 Sale of Cotton Futures Commitment Contracts**

*Inquiry*—A textile manufacturer entered into firm purchase

commitments for cotton at a very favorable price. At the present time, the corporation has an unusually long position of purchase commitments at a low fixed price. Some of these contracts may be sold at a tremendous profit which is extremely material in relation to normal operating income. This results from the tremendous increase in cost of raw cotton during recent months. The corporation has not sold such commitment contracts in the past; nor does it anticipate selling such contracts in the future.

Will the sale of cotton futures commitment contracts be considered an extraordinary item?

*Reply*—Paragraphs 19-22 of Accounting Principles Board Opinion No. 30 discuss the criteria for extraordinary items. In order to be classified as an extraordinary item, an event or transaction would have to be both unusual in nature and infrequent in occurrence. The transaction would not meet the “unusual nature” test. Making a commitment for future delivery of cotton to insure a source of supply would be part of the normal operations of a textile manufacturer. Any resulting gain or loss would therefore be considered ordinary. Although the corporation has not sold such commitment contracts in the past; nor does the corporation anticipate selling such contracts in the future, any gain realized on the sale of such a contract should not be considered an extraordinary item under APB Opinion No. 30. However, it should be shown as a separate line item in the income statement in accordance with paragraph 26 of the Opinion.

### **.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.

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➡ *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>\$1.00</u>	<u>\$ .08</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>44,500 sh.</u>	<u>43,000 sh.</u>
Income (before preferred dividends) . . . . .	<u>\$39,000</u>	<u>\$17,000</u>
Income per common share— assuming full dilution . . . . .	<u>\$ .88</u>	<u>\$ .40*</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>\$ .88</u>	<u>\$ .08</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 non-cumulative 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 .....	2,400 *
Adjusted .....	<u>\$54,000</u>

Adjustment of shares outstanding:

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

Primary earnings per share of common

stock—adjusted net income divided

by adjusted shares outstanding..... \$900

\* Computation of interest reduction:

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

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➤ *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*—Paragraph 20 of Statement of Financial Accounting Standards No. 13 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) when the sale or assignment is between related parties, the provisions of paragraphs 29 and 30 shall be applied, or (b) when the sale or assignment is with recourse, the profit or loss shall be deferred and recognized over the lease term in a systematic manner (e. g., in proportion to the minimum lease payments).

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.

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## TIS Section 6000

# SPECIALIZED INDUSTRY PROBLEMS

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## 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 issue a long-form report. The auditor made a cash count 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.

#### **.02 Provision for Loan Losses**

*Inquiry*—The Supplement to the AICPA Industry Audit Guide, *Audits of Banks* (1969), requires that a bank provide, from earnings, an estimated provision for loan losses based on a formula such as a five-year average of loan loss experience. Is this requirement a generally accepted accounting principle?

*Reply*—Page 2 of the Supplement indicates that a charge to expense for loan losses for the portion of the provision necessary to provide an appropriate valuation allowance, with the balance of the charge being made directly to undivided profits, may be appropriate to present fairly the results of operation in conformity with generally accepted accounting principles. It is also appropriate to include on the balance sheet, between total liabilities and capital funds, a reserve which consists of a valuation portion available for charging loan losses, a contingent portion not available for absorbing losses, and a deferred tax portion. Such a presentation of the valuation allowance and the deferred tax portion will generally not be material, and, therefore, it would not be necessary to take exception to the presentation. However, if the amounts should be material to the balance sheet, the matter should be disclosed in the notes to financial statements and should be referred to as an exception in the auditor's opinion.

**.03 Tax Effects of Provision for Loan Losses**

*Inquiry*—A bank has total assets of less than \$25 million and is on a cash basis. The Internal Revenue Code provides for buildup in the reserve for bad debts based on a formula which allows a tax deduction often considerably in excess of the actual losses sustained by the bank. For example, the allowable bad debt deductions for two consecutive years were \$50,000 per year, and the actual losses sustained were \$10,000 per year, which meant a tax write-off of \$40,000 each year in excess of actual losses. The applicable federal income taxes at 48% would be \$19,200 per year.

What is the proper method of handling the excess deductions for bad debts? Would Accounting Principles Board Opinion No. 23, which relates to this subject, be applicable to commercial banks?

*Reply*—Accounting Principles Board Opinion No. 23 deals with bad debt reserves of savings and loan associations, and states in paragraph 23 that the savings and loan association should not provide for income taxes on the difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserves and undivided profits of a savings and loan association. This requirement does not apply to commercial banks. The AICPA Industry Audit Guide, *Audits of Banks* (1969), would apply to this situation. Page 48 of the guide states:

It is also possible that for some banks, the amounts allowable under the Treasury tax formula may be in excess of provisions required for accounting purposes. In such instances, operating earnings should be charged for the provision computed under the management's method; to the extent that this provision is less than the tax deductible amount, operating earnings should include a provision for deferred income taxes. Any provision for loan losses in addition to the amount charged to operating expense, less the related tax effect, should be treated as an appropriation of undivided profits and should be included in the capital funds section of the balance sheet. If, in later years, the provision for loan losses charged to operations is more than the tax deductible amount, an appropriate portion of the reserve classified in capital funds should be restored to undivided profits.

See also the discussion of APB Opinion No. 11 on the bottom of page 48 of the guide.

**.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*—Paragraph 13a of APB Opinion No. 11 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.” Pages 47 and 48 of the AICPA’s Industry Audit Guide, *Audits of Banks* (1969), indicate 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



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*—Page 56 of the AICPA Industry Audit Guide, *Audits of Banks Including Supplement*, states:

However, because of the peculiarities of banks' capital accounts and the fact that a study of stockholders' equity is in process by AICPA, the Committee believes the use of par value by banks in accounting for stock dividends, is at least for the present, an acceptable practice.

Pages 43 and 44 of the AICPA Accounting Research Study No. 15, *Stockholders' Equity*, states:

*Predominant practice for stock dividends.* Nearly every publicly held corporation in the United States follows the recommendations of the committee on accounting procedure and New York Stock Exchange. Presentation and disclosure of details varies but the amount transferred from retained earnings to capital stock and additional capital equals the fair value of the additional shares issued. Corporations that distribute treasury shares as stock dividends also account for the fair value of the shares distributed.

The bulletin contains no definition or explanation of a closely held corporation as distinguished from a publicly held one and thus permits some leeway in adopting recommended practices. Corporations in some industries and in some states in addition to closely held corporations do not always follow the recommended practice. Banks are a notable example. Customarily, banks account for stock dividends by transferring from surplus or undivided profits to capital stock an amount equal to the par value of additional shares distributed. Some corporations account for stock dividends at the par or stated value of the stock distributed if the state permits dividends to be distributed from other than retained earnings.

Accordingly, the bank may conform with practice and capitalize a 10% stock dividend at par value instead of fair value. The fair value need not be disclosed.

➡ *The next page is 5221.* ⬅



## Section 6110

### ***Savings and Loan Associations***

#### **.01 Valuation of Repossessed Property**

*Inquiry*—A savings and loan association repossessed a large apartment complex that had a mortgage loan outstanding of approximately \$700,000. The current appraised value of the property is about \$400,000. Should the association's balance sheet show the repossessed property at \$700,000, or \$400,000, or some other amount? If the repossessed property is shown at \$400,000, how should the \$300,000 loss be reported?

*Reply*—Page 29 from the AICPA Industry Audit Guide *Audits of Savings and Loan Associations* (1973) states in part:

REO [real estate owned] acquired through foreclosure or purchased for sale or development should be carried at the lower of cost or market. The principle of carrying REO at the lower of cost or market is generally accepted. In those cases where the cost of REO is greater than the market value at the date acquired, such excess should be charged to income as a loan loss or to an allowance for loan losses to the extent previously provided by charges to income. If subsequent to the date acquired the cost of REO is greater than the market value of the property, the carrying value should be reduced to market value by establishing an allowance for loss or by directly writing down the cost of the property by charges against income.

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➡ The next page is 5241. ←



## Section 6120

### Credit Unions

#### .01 Modified Cash Basis Financial Statements

*Inquiry*—A credit union did not record accrued interest receivable on its loans outstanding and had not compiled the amount of accrued interest receivable. The credit union recorded interest income when collected. Is that a generally accepted method of accounting for a credit union?

*Reply*—Perhaps the most authoritative statement as to proper accounting and reporting for credit unions is published by the U.S. Department of Health, Education, and Welfare, Bureau of Federal Credit Unions, entitled *Accounting Manual for Federal Credit Unions* (May 1969). Page 2 of the manual states:

The system of accounting prescribed for federal credit unions by this manual is a modified cash basis. In general, the income is not accounted for until actually received. Expenses are accounted for when they become due and payable, regardless of whether or not actual disbursements for the expenses have been made.

Some large credit unions, however, may desire to use the accrual basis for accounting for some items. The accrual basis accounting procedures explained on pages 161 and 165 may be adopted by any federal credit union.

The auditor's responsibility in reporting on modified cash basis statements is discussed in Statement on Auditing Standards No. 14. [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*—Credit unions are not covered by the definition of not-for-profit organizations in paragraph 5 of the Introduction to Accounting Research Bulletin No. 43. Also, some accountants might consider credit unions as a for-profit mutual enterprise under paragraph 5. Accordingly, FASB Statement No. 12 applies to credit unions.

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➡ The next page is 5261. ←



## 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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➤➤➤ *The next page is 5361.* ←➤➤➤

## 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*—The Addendum to Accounting Principles Board Opinion No. 2 deals with accounting principles for regulated industries. The second paragraph of this section states:

However, differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses. Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues. For example, if a cost incurred by a regulated business during a given period is treated for rate-making purposes by the regulatory authority having jurisdiction as applicable to future revenues, it may be deferred in the balance sheet at the end of the current period and written off in the future period or periods in which the related revenue accrues, even though the cost is of a kind which in a nonregulated business would be written off currently. However, this is appropriate only when it is clear that the cost would be recoverable out of future revenues, and it is not appropriate when there is doubt, because of economic conditions or for other reasons, that the cost will be so recoverable.

#### **.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*—The Addendum to Accounting Principles Board Opinion No. 2 deals with accounting principles for regulated industries. Paragraphs 2-5 of the Addendum state:

However, differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses. Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues. For example, if a cost incurred by a regulated business during a given period is

treated for rate-making purposes by the regulatory authority having jurisdiction as applicable to future revenues, it may be deferred in the balance sheet at the end of the current period and written off in the future period or periods in which the related revenue accrues, even though the cost is of a kind which in a nonregulated business would be written off currently. However, this is appropriate only when it is clear that the cost would be recoverable out of future revenues, and it is not appropriate when there is doubt, because of economic conditions or for other reasons, that the cost will be so recoverable.

Accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses by orders of regulatory authorities, and occasionally by court decisions or statutes. The fact that such accounting requirements are imposed by the government does not necessarily mean that they conform with generally accepted accounting principles. For example, if a cost, of a kind which in a nonregulated business would be charged to income, is charged directly to surplus pursuant to the applicable accounting requirements of the regulatory authority, such cost nevertheless should be included in operating expenses or charged to income, as appropriate in financial statements intended for use by the public.

The financial statements of regulated businesses other than those prepared for filing with the government for regulatory purposes preferably should be based on generally accepted accounting principles (with appropriate recognition of rate-making considerations as indicated in paragraph 2) rather than on systems of accounts or other accounting requirements of the government.

*Generally Accepted Auditing Standards* lists four standards of reporting, the first of which says that "The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting." In reporting on the financial statements of regulated businesses, the independent auditor should observe this standard and should deal with material variances from generally accepted accounting principles (with appropriate recognition of rate-making considerations as indicated in paragraph 2), if the financial statements reflect any such variances, in the same manner as in his reports or nonregulated businesses.

Therefore, 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.

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➡ The next page is 5521. ←



## Section 6300

### *Insurance Companies*

#### **.01 Recognition of Commission Income by Insurance Agency**

*Inquiry*—A client, an insurance agency, receives certain payments from the insurance company, whose policies it sells, during the first year in which the policy is in force. These payments consist of “override” commissions and payments for expenses and allowances in selling any particular policy.

May the agency recognize a receivable in its accounts when the policy is accepted by the insurance company and before payment of any premium has been made by the insured?

*Reply*—The agency should recognize income as having been earned when the company approves the policy because the agency has completed its efforts and need do nothing else but await payment. The fact that a legal claim may or may not have arisen does not seem to present any compelling reason not to recognize income in view of the fact that a high percentage of the first-year fees so earned probably are eventually paid. An appropriate allowance should be provided for commissions which will not be collected because of lapses, deaths, etc.

#### **.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 agents' commissions are deducted. Generally, the efforts of the agency in connection with any individual policy terminate when collection is made or, at least, when the proceeds from the collections are

remitted to the insurance company. It would therefore seem that the recognition of income should occur when proceeds of the policy are received.

However, as there is a potential liability for returned premiums, it would appear that a reasonable allowance should be provided at this time for estimated commissions on the portion of the policies that may be cancelled in future years. Most finance companies should have adequate statistics upon which to base such estimates. If the finance company is new, there may be statistics available from similar enterprises.

**.03 Recognition of Income on Unclaimed Refunds Due Policyholders on Policy Cancellations**

*Inquiry*—An insurance agency has a material amount of accounts payable legally due to policyholders who have cancelled their insurance prior to the end of the policy term. The company does not notify these policyholders that these amounts are due them. When, if ever, should these credits be taken into income?

*Reply*—These accounts payable should continue to be reported as liabilities until such time as the individuals involved legally lose their claim to these amounts. Legal counsel should be consulted for an opinion as to whether these amounts would have to be paid over to the state under an escheat law.

Consideration should also be given to the appropriateness of notifying these policyholders that this money is due them.

**.04 Reserve for Future Claims of Title Insurance Company**

*Inquiry*—A title insurance company must place part of its premiums in a reserve for future claims. When should this reserve be recognized as income?

*Reply*—The jurisdiction under which a title insurance company operates usually requires that a stipulated percentage of premiums collected must be deferred in an unearned premium account. Generally, the unearned premium is taken into income over a ten-year period since most claims against title policies tend to occur during this ten-year period. However, actual claims are not charged to the unearned premium account. Actual claims are charged against income (title claims account) with the credit to "Reserve for Claims." The reserve for claims represents reported claims that have surfaced. The unearned premium account is intended to cover unsurfaced claims.

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➡ The next page is 5641. ⬅



## Section 6400

### 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* (1972), 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*—On page 3 of the AICPA's *Hospital Audit Guide* (1972) 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 Accounting Research Bulletin No. 51. In addition, the hospital corporation and the supporting corporation appear to come within the meaning of related organizations referred to on pages 11 and 12 of the *Hospital Audit Guide*. 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* (1972), 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*—Page 8 of the *Hospital Audit Guide* 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 hospital?

*Reply*—Page 19 of the AICPA Industry Audit Guide, *Medicare Audit Guide* (1969), deals with compensation of hospital-based physicians, and states, "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 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 *Hospital 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 they 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 Statement on Auditing Standards 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 paragraphs 10 and 11 and 31 through 33 of Accounting Principles Board Opinion No. 20. Since such adjustments are, by their nature, recurring items, they do not fit the criteria for an extraordinary item as discussed in para-

graphs 19 through 23 of Accounting Principles Board Opinion No. 30. The billings to the providers which are still subject to settlement should be disclosed in the notes to financial statements. Such disclosure is shown on page 48 of AICPA Industry Audit Guide, *Hospital Audit Guide* (1972):

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 on page 1 of the *Hospital Audit Guide* as voluntary, governmental, or proprietary, and the 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*—Pages 8 and 9 of the *Hospital Audit Guide* 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.

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»»»→ *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.

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➤➤➤→ *The next page is 5841.* ←➤➤➤

## Section 6500

### *Extractive Industries*

#### **.03 Disclosure of Contingent Liability for Royalties**

*Inquiry*—A company is forming a new subsidiary company which is purchasing the assets of an existing coal mining partnership. The total consideration is \$2,000,000, which is to be paid in the following manner:

- (1) \$750,000 in cash at the time of closing, which is considered as payment for coal land owned in fee, mining equipment, supplies, and other real estate, all of which have a fair market value of at least \$750,000.
- (2) \$1,250,000 to be paid as an overriding royalty of 10¢ per ton for all coal mined by the purchaser on the properties both owned and leased, acquired from the sellers or on any subsequently acquired properties.

Should the \$1,250,000 be recorded as a liability on the statement of financial position? If the \$1,250,000 is recorded as a liability and reduced monthly at the time that the 10¢ per ton overriding royalty is paid, how should the asset account be amortized?

*Reply*—It would be improper to reflect the total amount of the stipulated overriding royalty as a liability in the financial statements with a correlative charge being made to an asset account. The only possible rationale for setting these amounts up immediately, is to base such treatment on the contentions that a) from a going concern standpoint, it is likely the total amount in question will eventually be paid; and b) the transaction is viewed as involving a “premium” or “purchase price” undertaken to be paid for the acquisition of a leasehold. This rationale is erroneous since no immediate payment for the leasehold rights is made.

The \$1,250,000 is a contingent liability—a commitment entirely conditioned on the actual mining of coal. Accordingly, royalties should be accrued as a liability only when, and to the extent that, tonnage (to which the royalty applies) is actually mined. In the purchase agreement, there is 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.

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➤→ *The next page is 5941.* ←➤

## Section 6600

### *Real Estate*

#### **.01 Method of Recognizing Revenue from Commissions by Real Estate Brokerage Firm**

*Inquiry*—A client is a real estate broker and also manages real estate. The client is the exclusive broker for all its affiliates and acts as broker for outside parties as well. All of the affiliates invest in raw land for appreciation and occasionally improve and subdivide parcels. None of the properties are extensive enough to be considered “retail land sales companies.” Sales are probably half for second home sites and half for larger parcels bought for investment. Sales are usually for cash with an occasional mortgage taken by the seller. The client usually receives a gross brokerage commission of 10%-15% which is shared with its salesmen and co-brokers, retaining an average of 5%. Commissions are received at closing and co-brokers are paid shortly after the closing. Salesmen draw against firm purchase and sale agreements and are credited with the commission on closing. If a buyer fails to complete a purchase, his deposit is usually retained by the client in lieu of the brokerage commission, which legal counsel indicates is permitted under law.

The client records brokerage commission income when a firm purchase and sale agreement is accepted. This is an agreement which specifies price and all terms of sale, has no unusual or difficult conditions, and is secured by a deposit of 10% or more of the purchase price. This method was adopted by the client to more closely match revenues and expenses. Indirect selling expenses, including advertising, are treated as period costs. The costs of co-brokerage and salesmen's commissions are also accrued at that time. The client's contention is that the earnings process has been substantially completed, and the wait until closing (usually 30-90 days but occasionally longer) is a legal formality rather than an integral part of the broker's work. Very few sales are not closed, and the price and terms of sale rarely change. From an audit point of view, many of the open sales at year-end have closed by completion of the audit field work. The client's financial statements do disclose the method of accounting employed for brokerage commissions.

Is this present method of accounting for brokerage commissions considered acceptable?

*Reply*—The timing of revenue recognition for a service-type business is discussed in paragraphs 150 and 151 of Accounting Principles Board Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*. 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.

Paragraph 151 indicates,

Revenue from services rendered is recognized under this principle when services have been performed and are billable.

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 paragraph 60 of the AICPA Industry Accounting Guide *Accounting for Profit Recognition on Sales of Real Estate* (1973) 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 paragraph 56 of the AICPA Industry Accounting Guide, *Accounting for Profit Recognition on Sales of Real Estate*, 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*—AICPA Industry Accounting Guide *Accounting for Profit Recognition on Sales of Real Estate* (1973), paragraph 29 states in part:

Since payments by the buyer thus often apply first to released property, tests of a buyer's initial and continuing investment apply primarily to the relation between sales value of unreleased property not subject to release and unpaid debt on the property. That is, to recognize profit at the time of closing, a buyer's investment should include payments sufficient both to pay release prices on released property and to constitute an adequate initial and continuing investment . . . on property not released or not subject to release. Otherwise, profit should be recognized as if each release were a separate sale.

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 29.

**.05 Method of Recognizing Profit on Sale of Real Estate With Inadequate Buyer Investment**

*Inquiry*—Company A sold real estate to Company B. Company A does not have any obligation to perform significant activities after the sale, but the investment of Company B in the real estate at the time of the sale was not sufficient for Company A to recognize all the profit on the sale.

At the time of the sale, should Company A use the deposit method of accounting or the installment method of accounting? If Company A initially uses the installment method of accounting, may it change to accrual method at a later date?

*Reply*—Paragraph 17 of the AICPA Industry Accounting Guide, *Accounting for Profit Recognition on Sales of Real Estate*, concludes that "to recognize revenue and profit on a sale of real estate, a buyer's initial investment and his continuing investment should both be adequate to demonstrate his commitment to pay for the property."

"Profit Recognition on Real Estate Transactions," an article in the February, 1974, edition of *The Journal of Accountancy*, which discusses the guide, deals with inadequate buyer investment and the choice of accounting methods for recognizing income from sale transactions. Page 51 of the article indicates that if the transaction does not qualify for accrual accounting and another method is not specifically called for, the seller may select either to delay profit recognition through deposit accounting or use installment accounting.

Page 52 of the article indicates:

When conditions for accrual accounting are met, that method should be adopted as a change in accounting estimate. Accounting Principles Board Opinion No. 10 states that the installment or cost recovery method may be used as long as the circumstances exist that gave rise to a departure from the accrual method.



**.06 Qualification of Secured Note as Cash Equivalent**

*Inquiry*—Paragraph 15 of the AICPA Industry Accounting Guide, *Accounting for Profit Recognition on Sales of Real Estate* (1973), states that a note supported by the full faith and credit of the buyer is not a cash equivalent unless it can be clearly established to be a cash equivalent by sale of the note without recourse or by attainment of an irrevocable letter of credit from an established lending institution. Paragraph 22 seems to emphasize this point.

Does this mean that a note, even if secured by securities of a major corporation, would not qualify as a cash equivalent?

*Reply*—An argument could be made that where a note is collateralized by securities of a major corporation, the note is supported by more than the full faith and credit of the buyer. However, the intent of the guide is to restrict cash equivalency, and only those conditions mentioned in paragraph 15 would clearly establish cash equivalency. Where cash equivalency is claimed because of other circumstances, the burden of proof would be on those claiming the cash equivalency.

**.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*—Paragraph 21(a) of Accounting Principles Board Opinion No. 29 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. Does the AICPA Industry Accounting Guide, *Accounting for Profit Recognition on Sales of Real Estate*, mean that work performed by a purchaser is a partial down payment?

*Reply*—Paragraph 23 of AICPA Industry Accounting Guide, *Accounting for Profit Recognition on Sales of Real Estate*, 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.

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➡ The next page is 6041. ⬅

## Section 6610

### **Retail Land Sales Companies**

#### **.01 Applicability of Accounting and Auditing Guides to Real Estate Transactions**

*Inquiry*—A relatively small company invests primarily in lake frontage for a long-term investment rather than for immediate sales. The operating capital, however, does come from sales. In a normal year, only from five to ten lots are sold.

So far, the sales have not been from platted developments, although there are three small plats in process at the moment which will be available for sale next year.

Would the company be subject to the general principles for profit recognition on ordinary real estate transactions, or would the accounting be subject to retail land sales guidelines?

*Reply*—Some of the transactions entered into by the company would not come under the AICPA Industry Accounting Guide, *Accounting For Retail Land Sales* (1973), but would be accounted for under the Institute's Industry Accounting Guide entitled *Accounting for Profit Recognition on Sales of Real Estate* (1973). If the sale of a parcel is in the nature of a wholesale or bulk sale of land (see paragraph 8 of *Accounting for Retail Land Sales*), the guide *Accounting for Profit Recognition on Sales of Real Estate* would be applicable. Sales from the three small plats now in process may in fact be subject to the retail land sales guide. In other words, some transactions may come under one guide while others come under the other guide.

The final determination of which accounting guide applies to the transactions entered into by the company can only be made after considering all the surrounding circumstances.

#### **.02 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*—AICPA Industry Accounting Guide, *Accounting for*

*Retail Land Sales* (1973), discusses the reporting changes in financial position in paragraphs 57 and 58. Paragraph 57 states:

APB Opinion No. 19 . . . requires that a statement summarizing the changes in financial position be presented as a basic financial statement for each period for which an income statement is presented. The significance of long-term receivables and the deferral of revenue and income recognition in the financial position of retail land sales companies may lessen the validity of presentations of changes in financial position based on working capital. For that reason, the Committee considers that the required statement should be restricted to the sources and uses of cash rather than changes in working capital. . . . Also, because of its significance, this information should be provided for all periods presented whenever earnings information is reported.

The illustrative financial statements in this guide confirm the appropriateness of unclassified balance sheets.

### **.03 Change from Installment Method to Accrual Method for Retail Land Sales**

*Inquiry*—Paragraph 20 of AICPA Industry Accounting Guide, *Accounting for Retail Land Sales* (1973), states that accrual accounting should be applied to those projects in which collections on contracts are reasonably assured and all the prescribed conditions are met. Further, paragraph 23 states that accrual accounting should be adopted when the required conditions are met. Several small clients, with few financial or accounting personnel and a limited capability to generate the extensive data required to apply the accrual method properly, believe it to be in their best interest to remain on the installment method even after projects may qualify for accrual accounting. May installment accounting be retained or must the accrual method be adopted upon satisfaction of the conditions described in paragraphs 20-22?

*Reply*—As indicated in paragraph 23 of the Accounting Guide, “At the time that all four conditions are satisfied on a project originally recorded under the installment method, the accrual method of accounting should be adopted for the entire project. . . .” “Should” in this case, would be interpreted as a requirement, and remaining on the installment method or switching to the accrual method is not a matter of choice. Therefore, if the transactions meet the requirements for switching to the accrual method, the installment method should not be continued.

### **.04 Use of the Accrual Method for Sales of Unimproved Land**

*Inquiry*—Paragraph 20 of the AICPA Industry Accounting

Guide, *Accounting for Retail Land Sales* (1973), states several conditions which, if all are met, would require a company to use the accrual method rather than the installment method of accounting for land sales. One of the requirements is that the land should be useful for residential or recreational purposes at the end of the normal payment period. Does this provision preclude accrual accounting when unimproved land is sold and no improvements are promised by the seller?

*Reply*—Unimproved land with no improvements promised by the seller could, in fact, be used for certain recreational purposes. The guide does not define “recreational purposes.” Therefore, as long as the buyer will be able to use the property for the recreational purpose intended, the accrual method of accounting may be used, provided all of the other conditions have also been met.

**.05 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 the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales* (1973). 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 “. . . directly related to inven-

tories of unimproved land or to construction required to bring land and improvements to a saleable condition . . ." (see paragraph 51 of the Guide).

**.06 Proportionate Allocation of Development Costs to Subdivided Lots**

*Inquiry*—A company purchased a tract of undeveloped land with the intention of subdividing the tract into lots for sale as homesites. The municipal government requires that the company install sewer lines and construct streets for these lots. Some of the lots on the perimeter of the tract have access to existing streets and sewers, while the lots in the interior of the tract are completely undeveloped.

Should the development costs be capitalized to the tract as a whole or to the individual lots?

*Reply*—Paragraphs 51-55 of the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales* (1973), contain a discussion of costs to be capitalized and the allocation of such costs to parcels sold. Paragraph 51 states in part, "Costs directly related to inventories of unimproved land or to construction required to bring land and improvements to a saleable condition are properly capitalizable until a saleable condition is reached." If no additional development costs are needed to bring the perimeter lots to a saleable condition since there are already paved streets, water, and sewerage lines, a portion of the overall development costs should not be allocated to the perimeter lots. However, if some of the overall development costs are necessary to bring the perimeter lots to a saleable condition, a portion of those costs should be allocated to these lots as discussed in paragraphs 54 and 55. As indicated in paragraph 54, any reasonable allocation method which results in fairly matching costs with related revenues may be used. The method or methods selected should, of course, be consistently applied.

**.08 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. Would there be 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 Accounting Principles Board 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, the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales* (1973), indicates in the exhibits starting on page 25 that the financial statement basis for the land is cost. Paragraph 51 of the Guide discusses costs to be capitalized and states:

Costs directly related to inventories of unimproved land or to construction required to bring land and improvements to a salable condition are properly capitalizable until a salable condition is reached. Those costs would include interest, real estate taxes, and other direct costs incurred during the inventory and improvement periods. Interest is properly capitalizable if it results from (a) loans for which unimproved land or construction in progress is pledged as collateral or (b) other loans if the proceeds are used for improvements or for acquiring unimproved land. The carrying amount of capitalized costs should not exceed net realizable value. Interest not meeting the above criteria, selling expenses (except those deferrable as previously indicated), and general and administrative expenses should be treated as expenses of the period in which incurred.

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.

#### **.09 Financial Statement Presentation of Developed and Undeveloped Land Following Reappraisal**

*Inquiry*—A client corporation's inventory consists of developed and undeveloped land for sale in the ordinary course of business. Several years ago, when the client was first obtained, the only information available to determine cost was the remaining land cost on the books. This figure was definitely understated, and it was apparent that much of the land cost had been incorrectly charged off in prior years. An independent appraisal was made of all the land, and the remaining land cost on the books was allocated to the land based on the appraisal. Since the appraisal,

land has been charged off as it is sold based on this allocation. Since there is a material difference between remaining book cost and the appraised value of the land, and the remaining book cost is grossly incorrect, the corporation would like to present the land on the balance sheet at a current independently appraised figure in lieu of the remaining cost figure.

Would this use of an appraisal figure for the inventory be in accordance with generally accepted accounting principles?

*Reply*—With respect to the inventory of developed and undeveloped land, paragraphs 51 to 55, and paragraph 62 of the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales* (1973), indicate that the basis for inventory should be cost. Paragraph 67 indicates that the provisions of the guide should be applied retroactively and that annual reports which are prepared on the basis of the guide for the first time should include restated income statements for the latest three fiscal years and restated summarized income data for the two preceding them. The proposed recording of the inventory item would not be in accordance with generally accepted accounting principles, and, if the financial statements were prepared on that basis, a qualified or an adverse opinion would be required depending on the materiality of the effects of the appraisal. [Amended]

#### **.10 Recording Anticipated Discounts Not Otherwise Recognized**

*Inquiry*—AICPA Industry Accounting Guide, *Accounting for Retail Land Sales* (1973), paragraph 36 states:

Many companies have programs to accelerate collections of receivables or contract provisions that encourage prepayment with a reduction of the principal as the major incentive for prepayment. If a selling company can reasonably be expected to institute those or similar programs in the future, the measurement of initial consideration should be reduced through charges to income for anticipated discounts not otherwise recognized. Reductions that are given or taken sporadically should be charged to income in the period they occur.

The meaning of the statement relating to reduction of initial consideration for anticipated future discounts is unclear. It appears that a reserve should be set up for discounts in addition to the provisions for discounts which are implicit in the imputed interest rate. Is this the intended treatment for future discounts?



*Reply*—Paragraph 36 states, “. . . the measurement of initial consideration should be reduced through charges to income for anticipated discounts not otherwise recognized.” In discussing an appropriate interest rate in paragraph 33, the committee concluded, “. . . the effective annual yield on the receivable . . . should not be less than the minimum annual rate charged locally by commercial banks and established retail organizations to borrowers financing purchases of consumer personal property with installment credit.” Therefore, a key phrase in paragraph 36 is “not otherwise recognized.” If the interest rate used for calculating present value specifically includes a factor to recognize the effect of the future discounts, no further allowance is necessary. However, if the interest rate were such that the effective annual yield was exactly equal to the minimum annual rate charged locally by commercial banks and established retail organizations as discussed in paragraph 33, then an additional allowance would be necessary. This situation is used only as an example and should not be construed to mean that this is the only circumstance under which an additional allowance might be required. The reason that an additional allowance would be necessary is that the rate would not automatically provide for the discount since typically commercial banks and retail organizations which permit accelerated payment make an adjustment of interest, whereas paragraph 36 indicated that a reduction of principal is the major incentive for prepayment.

The sporadic reductions discussed in paragraph 36 should be charged to income in the period they occur because the effects of the sporadic reductions cannot be anticipated in the interest rate selected for present valuing purposes.

#### **.11 Discount Rate for Long-Term Receivables**

*Inquiry*—The AICPA Industry Accounting Guide, *Accounting for Retail Land Sales* (1973), states that long-term receivables should be valued at the discounted value. In determining the interest rate at which the receivables should be discounted, paragraph 33 of the guide states:

The Committee believes that generally the credit ratings of retail land purchasers approximate those of users of retail consumer installment credit provided by commercial banks and established retail organizations. Accordingly, the Committee concludes that the effective annual yield on the receivable (without a reduction for deferred

revenue or deferred income tax) should not be *less* than the minimum annual rate charged locally by commercial banks and established retail organizations to borrowers financing purchases of consumer personal property with installment credit.

Footnote 10 to paragraph 33 states:

The rate to be applied should be the one which is used predominantly in installment financing of soft goods and appliances. The Committee believes that for 1972 and recent prior years, a rate of not less than 12 percent is appropriate.

A client enjoys a special status with an insurance company and is able to borrow at interest rates of 5 to 7 percent. These low rates are passed on to the customers who are charged 7 to 8 percent interest on their obligations. Land prices are not inflated to offset the low interest rate.

Must the company discount its receivables at 12 percent as stated in the guide, or may the actual interest rates be used?

*Reply*—The company's situation would not warrant the use of a lower interest factor. Discounted values are basically meant to reflect opportunity costs, and market interest rates are generally used for calculating such costs. Adherence to paragraph 33 has even been required in states with strong and enforced maximum interest laws.

## **.12 Installment Method of Recognizing Sales of Cemetery Lots**

*Inquiry*—The AICPA Industry Accounting Guide, *Accounting for Retail Land Sales* (1973), requires that, under certain circumstances, the installment method be followed in recognizing sales. Paragraph 9 of the accounting guide exempts certain companies from its provisions if they meet the following criteria:

- a. The land is sold in an improved state; roads, water, sewers, and other amenities are completed and in place, and the land can be used immediately for construction.
- b. The seller gives the purchaser a deed at the time of sale; the purchaser gives the seller a cash down payment of at least 10 percent and a note bearing interest at an appropriate market rate that is legally enforceable against the purchaser's general credit and is collateralized by a first mortgage on the land. The seller makes credit checks as a regular procedure.
- c. The ratio of the loan to the value of the land is low enough that local banks and savings and loan institutions would loan money on the property at similar rates, and it is clearly evident that the

purchaser's notes are marketable at banks without substantial discount and without recourse to the seller.

If all these conditions are met, the Guide reasons that the exchanges can be completed at a readily measurable price, and the installment method would be inappropriate.

A cemetery meets all the conditions of the exemption in its sale of burial plots, except the state requires that sales be made under conditional sales contracts with title transferred upon the completion of the payments. Also, the loan-to-value ratio and note marketability tests cannot technically be met due to this state law.

Should the cemetery observe the rules set forth in *Accounting for Retail Land Sales* and account for its sales on the installment method?

*Reply*—Unless the sales of the cemetery lots meet all of the conditions specified in paragraph 9 of the guide, the principles in the guide would apply to such sales. However, the local law which requires that the sales be made under a conditional sales contract would have somewhat of a mitigating effect on the provision in paragraph 9(b) which requires the seller to give the purchaser a deed at the time of sale.

### **.13 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 paragraphs 54-55 of AICPA Industry Accounting Guide, *Accounting for Retail Land Sales*. Paragraphs 54-55 state:

#### ***Allocation of Costs to Parcels Sold***

54. Once costs to be capitalized are determined, a reasonable method is needed to allocate them to projects and parcels. The following methods of allocation are frequently used in practice:

- a. Area methods, using square footage, acres, frontage, or other measures based either on simple averaging methods or on some measure of yield differentials (e. g., equivalent lot yield, or geologically influenced factors such as slope and known soil problems).

- b. Value methods (gross or net after estimated future improvement costs), using mortgage release prices, estimated selling prices, or appraisals.
- c. Specific identification method, if possible and appropriate.
- d. Hybrid methods involving elements of two or more of the other methods.

Any reasonable method, consistently applied, that will fairly match costs with related revenues may be used. Since many expenditures are joint costs, the allocation method that will produce the fairest results depends to a large extent on the circumstances of each case. If the nature of the project is such that costs are reasonably identifiable with specific projects, one of the specific allocation methods (area methods, specific identification, or hybrids thereof) may be appropriate, provided that costs deferred to the future do not exceed net realizable value.

55. In view of the various uncertainties relating to retail land sales projects generally, the preferable allocation method in most situations should be based on relative values. The value approach to cost allocation is less likely to result in deferring of losses. As a rule, the most valuable property of the project is the easiest to improve and sell profitably. Allocating a higher proportion of cost to the more valuable property thus reduces the problem of recovery of the remaining investment.

#### **.14 Wholesale or Bulk Sales of Land**

*Inquiry*—Company A owns a large tract of land which it is improving with streets and utilities. The company reports sales of one acre lots to individuals, who place secondary residences on the lots, in accordance with the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales*. In addition to such sales, the company will sell 500 to 600 acre undeveloped tracts to nonaffiliated developers. Should the sales to developers be reported in accordance with the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales*?

*Reply*—Paragraph 8 of the AICPA accounting guide for retail land sales specifically states: "Wholesale or bulk sales of land and retail sales from projects comprising a small number of lots are subject to the general principles for profit recognition on real estate sales." The sales to developers constitute bulk sales and should be reported in accordance with the AICPA Industry Accounting Guide, *Accounting for Profit Recognition on*

*Sales of Real Estate.* A minimum down payment of 20% would apply to sales to developers. Exhibit A on pages 22 and 23 of the AICPA accounting guide for profit recognition on sales of real estate provides a schedule of minimum down payments expressed as a percentage of sales value.

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➡ *The next page is 6151.* ←



## Section 6700

### Construction Contractors

#### **.01 Distinction Between Long-Term and Short-Term Construction Contracts**

*Inquiry*—A construction company considers all contracts that are less than one year in duration as short-term contracts and accounts for them on a completed contract method. Long-term contracts are accounted for on the completed contract method or the percentage of completion method depending on other factors.

Does the distinction made by the company conform with generally accepted accounting principles?

*Reply*—Page 12 of the AICPA Industry Audit Guide, *Audits of Construction Contractors*, states, “The basis for recording income on construction-type contracts of long duration or term does pose accounting problems because the work often extends over several accounting periods.” Paragraph 194 of Accounting Principles Board Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, indicates, “The basic time period for which financial statements are presented is one year; ‘interim’ financial statements are commonly presented for periods of less than a year.” Therefore, the distinction between short-term and long-term contracts can be based on whether work on a contract extends beyond one year.

#### **.02 Audit Evidential Matter for Percentage of Completion Method—I**

*Inquiry*—A general contractor, who uses the percentage of completion method, employs his own engineers and will not allow the auditor to engage an outside expert to evaluate the state of the construction projects which are in scattered locations across the country.

The auditor plans to secure external evidence in the following manner:

1. Communicate directly with all subcontractors to arrive at a percentage of completion of jobs in process. In communicating, the auditor would get positive confirmation of the total contract, what payments a subcontractor has received

from the general contractor, and the subcontractor's estimate of the percentage of the contracted work that has been performed. After confirmation from all, or substantially all, of the subcontractors is received, this data would be assembled. An estimated percentage of completion would be arrived at by applying each subcontractor's percentage of completion and applying the total of these to the total of the subcontracts.

2. Estimated gross income on all jobs in process would be determined by getting confirmation from all customers as to the base contract and change orders authorized as of the statement date. The total contract and changes less the total subcontracts and an estimate of the general contractor's labor costs would indicate what the gross income would be.

Would it be advisable to have other auditors inspect the job sites in other parts of the country to see that a structure exists at a location as described by the contractor? Based on the auditing procedures previously described, can an opinion on the overall fairness of the financial statements be expressed?

*Reply*—Pages 43-55 from the AICPA Industry Audit Guide, *Audits of Construction Contractors* (1965), state that it is appropriate to obtain an independent architect's estimate of completion if available. However, the auditing steps previously outlined to secure external evidential matter as to the percentage of completion of a particular job that has been performed to date would be a satisfactory alternative. The results obtained should be compared with the project engineer's estimate of completion.

The discussion of "job sites" in the audit guide indicates the advisability of visiting the job sites is not only to verify that a structure exists at the location as described by the contractor, but also to examine the accounting records and review the internal control procedures. Based on auditing procedures previously outlined and the auditing procedures set forth in pages 43-55 of *Audits of Construction Contractors*, it would be possible to render an opinion on the overall fairness of presentation of the financial statements.

### **.03 Audit Evidential Matter for Percentage of Completion Method—II**

*Inquiry*—A contractor employs the percentage of completion



method and computes income earned by multiplying the total contract price by a fraction—the numerator of which is costs incurred to date, and the denominator is costs incurred to date plus estimated additional costs to complete the job.

If the contractor does not have an independent engineer's estimate of the progress of the job, should the auditor disclaim an opinion on the financial statements?

Reply—The AICPA Industry Audit Guide, *Audits of Construction Contractors* (1965), states that it is appropriate to obtain an independent architect's estimate of completion if available. An effort should be made to obtain the client's project engineer's estimate of completion and review contracts with the contractor's engineering personnel who are familiar with and responsible for contracts in process. Engineering personnel should be informed as to the purposes of this review in order to obtain the utmost cooperation, and their comments should be given consideration in the evaluation of contract profits.

To secure external corroborative evidential matter as to the percentage of completion of a particular job, the auditor should communicate directly with all subcontractors. In communicating, request positive confirmation of the total subcontract, what payments have been received from the general contractor, and the subcontractor's estimate of what percentage of the work he has contracted to do has been performed. After confirmation from all, or substantially all, of the subcontractors is received, this data is assembled. An estimated percentage of completion can be arrived at by applying each subcontractor's percentage of completion to the related contract and applying the total of these to the total of the subcontracts.

Accordingly, it would be possible to render an unqualified opinion on the contractor's financial statements.

**.04 Effect on Auditor's Opinion of Exclusion of Production Overhead Costs on Completed Contracts and Contracts in Progress**

*Inquiry*—Accounting Research Bulletin No. 45 discusses in paragraph 10 the propriety of allocation to contract costs (rather than to periodic income) of general and administrative expenses. Such allocation is left optional by the paragraph. In the AICPA Industry Audit Guide, *Audits of Construction Contractors* (1965), the same statement is made in reference to "general administrative expenses and similar general expendi-

tures sometimes described as overhead and indirect expenses.” On page 46 of the audit guide, mention is made of the allocation of “overhead applied on engineering and manufacturing,” but no principle is stated.

Nowhere in the literature is there a statement as to the necessity of allocating production overhead in the case of contractors. Is the allocation of such production overhead covered by statement 3 of Chapter 4 of Accounting Research Bulletin No. 43 even though contracts in process are not “inventory”? Is the allocation of production overhead by contractors so generally accepted that it was not necessary to mention it in ARB No. 45? Where production overhead, such as tools and supplies, depreciation of equipment, etc., is material, and where the contractor is engaged in large contracts having terms well over a year, can the auditor give an unqualified opinion to a statement which charges all such costs to periodic expense?

*Reply—Audits of Construction Contractors* as well as Accounting Research Bulletin No. 45 should have made explicit reference to the principle of allocating “production” or “construction” overhead to contracts in progress and to contracts completed during the fiscal period. However, in the Audit Guide mentioned above, there is ample internal evidence in the discussion clearly implying that “absorption costing” is required practice in contractor accounting as well as in the inventory accounting of a manufacturer. For example, part (d) on page 46 of the Audit Guide refers to “overhead applied on the engineering and manufacturing”; pages 45-46 indicate clearly that contracts in process should be charged with costs relating to equipment used on the project; pages 26-30 indicate clearly that most operators establish a unit cost of operation for pieces of equipment and charge the jobs at these rates; and page 28 states:

Operating and maintenance costs of miscellaneous small tools and equipment are usually charged to overhead accounts rather than specific jobs. However, a contractor may allocate such costs directly to specific jobs where the costs relate to such jobs.

Statement 3 of chapter 4, “Inventory Pricing,” in ARB No. 43 is also applicable. Note especially the sentence, “It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure.” To exclude all construction overhead from a contractor’s accumulated contract costs carried forward is a “prime costs” basis

which carries direct costing one step further, and direct costing is not authoritatively accepted as a basis for external financial reporting.

Based on the foregoing, it seems that if the exclusion of construction overhead from accumulated contract costs has a material effect on net income, the auditor would be obliged to issue either a qualified or an adverse opinion.

#### **.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, Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*, was construed to apply to the negotiated contracts, and the profit on uncompleted negotiated 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*—Accounting Research Bulletin No. 45 specifically states in paragraph 1 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.

Paragraphs 13 and 16-18 of Chapter 11A 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 ten or fifteen percent 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.

#### **.07 Acceptability of Two Sets of Financial Statements Based on Different Accounting Methods**

*Inquiry*—A construction contractor with long-term contracts maintains its records on a completed contract basis. Information necessary for preparing financial statements on a percentage of completion basis is available. The contractor’s surety has requested that the contractor change to the percentage of completion basis. Is it possible to issue two sets of financial statements based on two different accounting methods?

*Reply*—Paragraph 15 of Accounting Research Bulletin No. 45 states that 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. Although the completed contract method may be an acceptable alternative method under such circumstances, it is unlikely that for any one company the use of both these methods could result in two different sets of financial statements, each of which fairly presents financial position and results of operations.

**.08 Cost of Materials Above Net Realizable Value**

*Inquiry*—A construction company is building a condominium project for which it has received a loan commitment that funds will be available for completion of the project. The company accounts for construction costs under the completed contract method. The cost of steel and cement for the project to date, reported as construction in progress (inventory) on the financial statements, is above current net realizable value for those items. Should the inventory of steel and cement costs be written down to current realizable value?

*Reply*—Accounting Research Bulletin No. 43, chapter 4, deals with inventory pricing. Since funds have been committed to complete this project, the determination of the inventory values for the steel and cement should be made within the context of the assurances that the project will be completed with the contemplated revenues exceeding the total cost of the project upon completion of the construction. Assuming no going-concern problems, it is not appropriate to mark down the steel and cement used to date on the basis of lower current prices. There should be footnote disclosure of the pricing methods used (cost in this case); the assurances that funds will be available for completion of the project; and that revenues to be realized upon completion are expected to exceed total costs.

**.09 Classification of Billings in Excess of Costs**

*Inquiry*—A construction company on the completed contract method would like to classify “billings in excess of costs on uncompleted contracts” as a noncurrent liability. Is that classification acceptable?

*Reply*—A footnote to page 93 of the AICPA Industry Audit Guide, *Audits of Construction Contractors*, states:

Paragraph 12 of Accounting Research Bulletin No. 45 states that "When the completed contract method is used . . . an excess of accumulated billings over related costs should be shown among the liabilities, *in most cases as a current liability.*" [Italics supplied.] The phrase "in most cases" was inserted as a recognition of the possibility of situations arising in which it would be unreasonable to require the entire amount of the excess to be treated as a current liability. In such cases, a "suspense" or "deferred credit" category could properly be used for the profit element. [See *Journal of Accountancy*, February 1956, page 63.]

Attempts to classify a portion of "billings in excess of costs on uncompleted contracts" as a noncurrent liability should be discouraged. However, a noncurrent classification may not necessarily constitute a departure from generally accepted accounting principles.

#### **.10 Payments for Landfill Rights**

*Inquiry*—A construction contractor pays for rights allowing the contractor to extract a specified volume of landfill from a third party's property for a period of three years. How should the payment for landfill rights be classified in the contractor's balance sheet?

*Reply*—Until the landfill is extracted, the contractor should classify the payment for landfill rights as a deferred charge. The portion of the landfill payment related to the volume of landfill extracted should be reclassified as project costs. A deferred charge remaining at the termination of the agreement should be written off as an expense.

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➡➡➡ *The next page is 6351.* ⬅⬅⬅

## Section 6910

### *Investment Companies*

#### **.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.

#### **.02 Basis for Valuation of Investments by Pension and Profit Sharing Funds**

*Inquiry*—When a reporting entity is a pension or profit sharing plan, would fair presentation require that the fund assets be valued at market? This method of valuation would seem to be consistent with the intent of most plans regarding the allocation of current earnings or losses to the various participants' equity.

*Reply*—Pensions and profit sharing plans are, in fact, a form

of investment company. Current practice for financial statements of investment companies is presented in the AICPA Industry Audit Guide, *Audits of Investment Companies* (1973). Open-end investment companies are required by the Guide to report their investments at market, while closed-end funds are permitted to present investments either at cost with disclosure of market, or at market with disclosure of cost. The problems of pension funds and profit sharing funds are closer to those of open-end investment companies than to closed-end companies. Therefore, it would be appropriate for a pension or profit sharing plan to show its investments in marketable securities at present market value, with disclosure of historical costs.

### **.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).

Accounting Series Release No. 118, *Accounting for Investment*



*Securities by Registered Investment Companies*, also includes a discussion of securities valued “in good faith.”

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➡ *The next page is 6411.* ←



## Section 6920

# Voluntary Health and Welfare Organizations

### **.02 Classification of an Organization with Clubhouse and Membership Dues as a Voluntary Health and Welfare Organization**

*Inquiry*—The principal source of revenue of an organization is membership dues, although some revenues come from minor fund raising activities. The group's activities run the gamut from rehabilitating drug addicts to improving the reading skills of school children. In addition to these activities, the organization maintains a clubhouse (including a food and beverage operation) for the use of its members as a headquarters and meeting place. Should this organization be classified as a "voluntary health and welfare organization" as defined in the preface to the AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (1974), which states, "As a group, voluntary health and welfare organizations include those nonprofit organizations that derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes connected with health, welfare, or community services."

*Reply*—The fact that membership dues are the principal source of revenues and a clubhouse is maintained does not preclude the organization from being considered a voluntary health and welfare organization under the guide. In many cases, membership dues to a service club can be considered similar to voluntary contributions. In determining whether the club is a voluntary health and welfare organization, the primary consideration should be the nature of its activities. If the functions of this organization are directed primarily toward social welfare and health activities, it should probably be considered a voluntary health and welfare organization.

### **.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*—Chapter 5 of the AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (1974), 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.

#### **.06 Applicability of Audit Guide to Religious Order**

*Inquiry*—A religious order with a vow of poverty conducts gratis missionary services. The order's predominant source of income is from voluntary donations which are received, not directly, but through an affiliated conduit organization. No services are rendered to the affiliated organization in return for the contributions. Does the AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, apply to the religious order?

*Reply*—The editor of the accounting and auditing column in *The Journal of Accountancy* commented on the applicability of the Guide on pages 79-80 of the January 1976 issue. His opinion states in part:

. . . the organizations considered as being covered specifically by the audit guide should be those that meet the criteria in the definition of voluntary health and welfare organizations in the guide. The organization (1) should be involved with health, welfare or community services, (2) should not be operated for profit and (3) should "derive [its] revenue primarily from voluntary contributions." . . . Listing organizations to which the guide applies is not possible; the circumstances of an individual organization need to be evaluated.

Accordingly, the religious order should follow the recommendations in the Guide. [Amended]

**.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*—Page 5 of the AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, 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.

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➡ *The next page is 6471.* ←

## Section 6930

# Employee Health and Welfare Benefit Funds

### .01 Computation of Liability for Accumulated Eligibility Credits

*Inquiry*—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
Liability for accumulated eligibility credits	<u>\$570,000</u>

*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 Industry Audit Guide, *Audits of Employee Health and Welfare Benefit Funds* (1972), states 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 recorded in the “liability under the claims incurred but not reported” and the “liability for accumulated benefits” sections. 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.

### **.03 Financial Statement Presentation of Underwriting Loss**

*Inquiry*—The administrator of an employee health and welfare benefit fund has questioned an item on the fund’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 Loss,” and is included among expenses in the “Statement of Operations and Fund Balance.”

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. There is no assurance that future underwriting “gains” will occur to permit recovery of past deficits.

Should the underwriting loss be reflected in the financial statements in the year in which it occurs?

*Reply*—Pages 9 and 10 of the AICPA Industry Audit Guide, *Audits of Employee Health and Welfare Benefit Funds* (1972),



discusses accrued experience rating adjustments. That section of the audit guide indicates that “experience ratings, determined by the insurance company or by estimates, may also result in a premium deficit which should be recorded as a liability only in the event that the deficit will be applied against the amounts of future premium or experience rating refunds.” 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 guide. Therefore, the “underwriting deficits” should be reflected as a liability with accompanying footnote disclosure.

**.04 Requirement for a Payroll Audit of a Welfare and Pension Fund**

*Inquiry*—In connection with the audit of a welfare and pension fund, must a payroll audit be performed?

*Reply*—The AICPA Industry Audit Guide, *Audits of Employee Health and Welfare Benefit Funds* (1972), discusses on pages 20 and 21 the circumstances under which the independent auditor should audit payrolls. In general, payroll audits should be performed whenever the engagement calls for the determination of the propriety of contributions made to a welfare and pension fund.

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»→ The next page is 6521. ←«



## Section 6935

### ***Profit Sharing 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 as “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.

Paragraph 8 of Accounting Principles Board Opinion No. 22, 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 gener-

ally accepted accounting principles. 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 Applicability of AICPA Industry Audit Guide to Savings Fund**

*Inquiry*—Company A and its employees contribute to a savings fund which is under the control of a corporate trustee (a bank) and which is for the exclusive benefit of the employees or their beneficiaries. Does the AICPA Industry Audit Guide, *Audits of Employee Health and Welfare Benefit Funds*, apply to the savings fund?

*Reply*—The Guide does not apply to such savings plans but relates only to health and welfare benefit funds.

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➡ The next page is 6551. ←

## Section 6940

### Franchisors

#### .01 Method of Accounting for Sale of Territorial Franchise Right

*Inquiry*—A client sells territorial franchise rights to region managers for \$30,000 with ten percent taken in cash and the remainder as a note. The region manager in turn sells franchises in his territory. The note is payable at the rate of \$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, the AICPA Industry Accounting Guide, *Accounting for Franchise Fee Revenue*, states on page 12, "In general, with respect to initial franchise fees related to area franchises, an attempt should be made to follow the same principles described previously for the sale of individual franchises." The committee recommended a test of substantial performance for revenue recognition from individual franchises on page 8 which indicates:

. . . in keeping with conventional accounting theory and practice, revenue should be recognized when the franchise sale transaction is consummated, i.e., when any material conditions which attach to the sale have been substantially performed. Substantial performance as to the franchisor means that (1) he has no remaining obligation or intent—by agreement, trade practice or operation of law—to refund any cash already received or to excuse nonpayment of any unpaid notes; (2) substantially all of the initial services of the franchisor required by the contract have been performed; and (3) any other conditions which affect consummation of the sale transaction have been met.

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 (1) above.

Since payment of the notes is on the basis of specific performance (i.e., at the rate of \$1,000 per store sold in the region), as a practical matter, a reasonable basis for recognizing deferred revenue would be over the estimated number of stores to be opened in a region.

With regard to the costs of selling the territories, page 17 of the guide states, “. . . franchisors should ordinarily defer costs relating to specific franchise sales for which revenue has not yet been recognized. Indirect costs of a regular and recurring nature which are incurred irrespective of the level of sales such as general selling expenses and administrative expenses should be expensed as incurred.” 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.

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➡ *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*—Several audit clients are school districts which follow 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*—The AICPA Industry Audit Guide, *Audits of State and Local Governmental Units* (1974), indicates that when the governmental unit prepares its financial statements on a cash basis paragraph 8 of Statement on Auditing Standards No. 14 should be followed. The suggested opinion in 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, and



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 assessments, etc.

Are these procedures necessary, or would it be sufficient to merely confirm collections and receivables with the county?

*Reply*—According to the AICPA Industry Audit Guide, *Audits of State and Local Governmental Units* (1974), confirmation of the tax revenues with the county would be sufficient, but, in addition to confirming the receivables with the county government, the auditor should consider examining the underlying documents supporting the hospital district's right to amounts included as receivables.

#### **.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 on pages 10-12 of The AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*. There are essentially four categories of interfund transactions in addition to interfund loans and advances. While the transfers described are not specifically referred to in the guide, they have characteristics of the first category of transfer discussed on page 10. The first category consists of transfers which are revenues to the recipient and expenditures to the disbursing fund. The transactions would be treated as revenues or expenditures if conducted with outsiders.

Therefore, the transfers should be accounted for as expenditures of the general fund and nonoperating revenue of the recreation fund.

#### **.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*—Page 14 of the AICPA Audit Guide, *Audits of State and Local Governmental Units*, states:

Generally revenues should be recorded on the accrual basis only if they are susceptible to accrual. Being susceptible to accrual implies more than being measurable. Revenues considered susceptible to accrual are those revenues that are both measurable and available. In substance, "available" means that the item is a resource that can be used to finance the governmental operations during the year.

Since the terms of the settlement call for five equal installments over the next five years, one fifth of the settlement should be reported each year as collected and the settlement should be disclosed in a note to the financial statements.

#### **.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, which 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*—The AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*, page 136, states that Enterprise Funds are used to account for the financing of services to the general public where all or most of the costs involved are paid in the form of charges to the users of the services. A school cafeteria system that is financed by grants and donations does not conform to the criteria for an Enterprise Fund.

**.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.

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➡ 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.



**.08 Applicability of Audit Guide to Private Schools**

*Inquiry*—A private school applied for accreditation. The accrediting commission reviewed the school's audited financial statements and told the school that the financial statements did not conform with recommendations in the AICPA Industry Audit Guide, *Audits of Colleges and Universities*. Does the Guide cover the financial statements of private schools?

*Reply*—The preface of the Guide states:

The requirements of elementary and secondary schools or school systems have not been considered, but the guide may be useful to the auditors of private or independent schools since the accounting and financial reporting practices recommended by the National Association of Independent Schools have closely paralleled those included in *College and University Business Administration*, Revised Edition, published in 1968 by the American Council on Education, Washington, D. C.

Although the recommendations in the Guide do not specifically apply to private schools, a school would need to comply with the requirements of the accrediting commission, which may include conformity with the recommendations in the Guide.

**.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.

**.10 Effect of "Going Concern" Problems on Auditor's Opinion**

*Inquiry*—Over the past few years, a small church-related college has experienced cash deficits which are expected to continue for the next few years. The cash deficits have raised serious questions as to the ability of the college to continue operations. How might an auditor's opinion be affected by such circumstances?

*Reply*—Depending on the significance of the "going concern" uncertainties affecting the financial statements, a qualified opinion or a disclaimer of opinion because of the uncertainties may be necessary.

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➡ *The next page is 6751.* ⬅

## Section 6970

### **Entertainment Industry**

#### **.01 Motion Picture Participation Agreement Payments**

*Inquiry*—Page 9 of the AICPA Industry Accounting Guide, *Accounting for Motion Picture Films* states in part, “Frequently, talent involved in the production of a motion picture film are compensated, in part or in full, with a participation in the income from the film. Determination of the amount of compensation payable to the participant is usually based on percentages of revenues or profits from the film from some or all sources. Television residuals are a form of participation and are generally based on the number of times the film is exhibited on television. The Committee has concluded that, when it is anticipated that compensation will be payable under the participation agreement, the total participation should be charged to expense in the same manner as amortization . . . in the same ratio as current gross revenues bear to anticipated total gross revenues.”

Should participation payment accruals start after net profits exist (breakeven method), or with the first gross receipts of the picture?

Does the term “gross revenues” literally mean gross rentals from theatrical exhibition or does it mean gross rentals reduced by applicable distribution fees and costs?

*Reply*—The participation expense should be estimated and accrued based on the initial gross receipts. If estimated net profits do not achieve their expected levels, the participation liability should be adjusted. The “breakeven” method should not be used.

The term “gross revenues” as used in the Guide means gross rentals from theatrical exhibitions without reduction for distribution fees and costs.

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## TIS Section 7000

# SPECIALIZED ORGANIZATIONAL PROBLEMS

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- .01 Combination of Indirectly Owned Companies
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- .04 Combination of Related Companies—I
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- .01 Withdrawals in Excess of Accumulated Retained Earnings
- [.02] Reserved
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**7920 Domestic International Sales Corporations**

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- [.02] Reserved
- .03 Sales to Domestic Companies Classified as Export Sales

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**➡ 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*—In the Industry Audit Guide, *Audits of Personal Financial Statements*, the following statement appears on page 4:

In the case of the individual proprietorships, there may be little, if any, distinction between personal and business assets and liabilities, except on a completely arbitrary basis determined by the proprietor.

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 control to justify an auditor forming 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*—Pages 21-25 of the AICPA Industry Audit Guide, *Audits of Personal Financial Statements* present illustrative personal financial statements. Note 1 to these statements shows a summary statement of the net assets of a proprietorship and discloses the proprietorship's income before provision for income

taxes for the year then ended. There is no requirement that an income tax provision be set up on the financial statements of a proprietorship since the proprietor's total income tax is affected by other matters not related to the business.

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➤➤➤ ➤ *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*—Paragraph 13(a) of APB Opinion No. 11 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 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.

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➤➤➤→ *The next page is 7171.* ←➤➤➤

## Section 7300

### **Not-For-Profit Organizations**

#### **.01 Titles and Caption for Final Figure in the "Income Statement" of a Nonprofit Organization**

*Inquiry*—The principal activity of a tax-exempt organization is handling labor-management negotiations for employers. The organization's income is principally derived from member dues, administration fees, and interest. Expenses of the organization consist of usual operating expenses such as salaries, taxes, rent, supplies, etc. What is an appropriate title for the income statement of this organization and what is an appropriate caption for the final figure in the income statement?

*Reply*—Appropriate titles for the income statement are "Statement of Operations" or "Statement of Revenue and Expense". Appropriate captions for the final figure in the statement are "Excess of Accrued Revenues over Accrued Expenses" or "Net Operating Revenue" or "Net Balance of Revenue over Costs and Expenses." This avoids such words as "income," "earnings," "gain," or "profit."

A "single-step" format is appropriate for the income statement. Such a format would group members' dues, administration fees, and interest to arrive at total revenues, then group the usual operating expenses to arrive at a total to be deducted from such revenues in determining the final figure in the statement.

#### **.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.

### **.03 Accounting for Fixed Assets of Private Club**

*Inquiry*—What is the proper method for a nonprofit private club to account for property additions? Should the asset additions be capitalized at cost and depreciated, or should they be recognized currently as expenses?

*Reply*—Unless a club levies special assessments, it must recover the costs of its services to continue in operation. Since depreciation is a cost of operating a club, the cost of property should be recorded as an asset and depreciated over its useful life.

If the financial statements of a club purport to present financial position and results of operations, but material costs of property are not recorded as assets and depreciated, the auditor should qualify his opinion. [Amended]

**.04 Effect on Auditor's Opinion of Omission of Depreciation on Fixed Assets of a Museum**

*Inquiry*—May an unqualified opinion be given on the financial statements of a museum which does not include charges for depreciation on fixed assets? The museum is not primarily supported by the public, but it provides various educational programs.

*Reply*—Pages 11-13 of the AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (1974), contain a discussion of depreciation which concludes that depreciation expense “should be recognized as a cost of rendering current services and should be included as an element of expenses in the statement of support, revenue, and expenses of the fund in which the assets are recorded and in the statement of functional expenditures.” The intent of the voluntary health and welfare guide was to set broad nonprofit guidelines, but it is a matter of judgment as to whether the guide specifically applies to museums, since it can be argued that museums are closer to educational institutions, such as colleges and universities.

According to the AICPA Industry Audit Guide, *Audits of Colleges and Universities*, pages 9-10, depreciation is not charged as an operating expense, but the provision may be reported in the statement of changes in the balance of the investment-in-plant fund.

An unqualified opinion may be issued on the financial statements of a museum which does not depreciate its fixed assets on the basis that the museum is more in the nature of an educational institution than a voluntary health and welfare organization.

**.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 com-

panies are incompatible for consolidation. Should the investments, however, be accounted for by the equity method?

*Reply*—Accounting Principles Board Opinion No. 18, paragraph 2(b) indicates that the Opinion does not apply to investments in common stock held by nonbusiness entities. While ownership of voting preferred stock would be used to test for the 20% ownership under paragraph 17, the equity method itself is applied only to investments in common stock. Therefore, although use of the equity method may not be required, it would be desirable to account for the bureau's investment in the equipment parts corporation under the equity method. But the equity



method should not be used for the preferred stock investment which should still be carried at cost.

**.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*—Does Accounting Principles Board Opinion No. 29, *Accounting for Nonmonetary Transactions*, apply to contributed services such as unpaid corporate directors or services to tax-exempt organizations?

*Reply*—In defining certain terms used in APB Opinion No. 29, paragraphs 3(c) and (d) state:

Exchange (or exchange transaction) is a reciprocal transfer between an enterprise and another entity that results in the enterprise's acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.

Nonreciprocal transfer is a transfer of assets or services in one direction, either from an enterprise to its owners (whether or not in exchange for their ownership interest) or another entity or from owners or another entity to the enterprise. An entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

Based upon the above definitions, APB Opinion No. 29 would apply to contributed services received. The basis of accounting for the transaction should be in accordance with paragraph 18 of the Opinion which concludes, “. . . in general, accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions.”

**.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), contains an explanation of custodian funds on page 3.

**.10 Accounting for Annuity Funds Received by Retirement Home**

*Inquiry*—A client operates a nonprofit retirement home for the aged. The corporation accepts money from individuals in exchange for annuities based on their life expectancies. How should the nonprofit organization account for the annuities?

*Reply*—The AICPA Industry Audit Guide, *Audits of Colleges and Universities*, indicates that the actuarial method should be used to account for “annuity funds”. Pages 50 and 51 of the Guide state:

The actuarial method requires the recording of the assets at cost or at fair market value at date of receipt. The liability side includes an account for the present value of the aggregate liability for annuities payable, based upon acceptable life expectancy tables, and an account for the fund balance or deficit. When a gift is received, the present value of the annuities payable is credited to the liability account and the remainder to the fund balance. Investment income and gains are credited, and annuity payments and investment losses are charged, to the liability account. Periodically, an adjustment is made between the liability and the fund balance to record the actuarial gain or loss due to recomputation of the liability based upon the revised life expectancy. By recognizing the present value of the annuities as a liability, the actuarial method meets the requirements of generally accepted accounting principles and therefore should be used.

[Amended]

**.11 Auditor's Report on Incomplete Statement of Receipts and Disbursements**

*Inquiry*—A CPA has completed the audit of a large nonprofit organization and has issued his report on the client's balance sheet and a statement of changes in fund balances. The client wishes to include the auditor's report in its published annual report; however, they wish to substitute a statement summarizing receipts and disbursements for the statement of changes in fund balances.

The CPA believes the statement of receipts and disbursements does not fairly present the activities of the organization, for it

omits substantial gifts from a major contributor, gains from investment transactions, and increases in the capital fund.

Is the CPA correct in issuing an adverse opinion, or can the deficiencies be corrected by a note to the statement?

*Reply*—If the statement of receipts and disbursements is supposed to represent receipts and disbursements of all fund accounts, and if there has been a substantial omission, an adverse opinion is in order.

A note to the statement to the effect that a material item has not been included in the receipts does not cure an inherent statement deficiency.

## **.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 viewed 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 treated as period costs.

APB Opinion No. 20, which relates to correction of an error in paragraphs 13, 36, and 37, FASB Statement No. 16, paragraph 11, and the Institute's Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, page vi, indicate that the above described change in accounting principle should be reported as a prior period adjustment. [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 organization 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.

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➡ The next page is 7351. ←



## Section 7400

### ***Related Parties***

#### **.04 Disclosure of Salary Paid to Owner-Manager**

*Inquiry*—Does *Statement on Auditing Standards No. 6* require disclosure of the salary paid to an individual who is both a member of management and a principal stockholder?

*Reply*—Paragraph 3 of SAS No. 6 states, in part:

Examples of related party transactions include transactions between a parent company and its subsidiaries, transactions between or among subsidiaries of a common parent, and transactions in which the reporting entity participates with other affiliated businesses, with management <sup>4</sup> or with principal stockholders (or other ownership interests).

Note 4 states:

Compensation arrangements, expense allowances, and other similar items in the ordinary course of business are not deemed to be related party transactions for purposes of this Statement.

The exclusion in Note 4 applies when an individual is an owner-manager. Therefore, the salary paid to the owner-manager does not have to be disclosed under SAS No. 6.

#### **.05 Loans to Bank Officers and Directors**

*Inquiry*—A bank makes loans to its officers and directors. Does *Statement on Auditing Standards No. 6* 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 SAS No. 6.

A bank should disclose loans to officers, directors, and employees when such loans are material individually or in total.

➡ *The next page is 7401.* ←





## Section 7500

### ***Estates and Trusts***

#### **.01 Trust Funds for Perpetual Care of Cemetery**

*Inquiry*—In accordance with state laws, a cemetery conducting business as a closely held corporation is required to set aside in a perpetual trust, with a corporate trustee, a certain amount from the sales proceeds of lots and crypts to be used for the perpetual care of the cemetery. The cemetery has no recourse to the principal of the trust, but receives all income earned by the trust assets. Before the state law was enacted, the cemetery made contributions to a similar trust as part of the contract of sale of lots. The cemetery contends that assets deposited with the trustee should not be reflected as part of its financial position because it has no claim to the corpus of the trust. Is this an appropriate method to account for such a trust?

*Reply*—The cemetery management is technically correct in contending that the assets deposited with the trustee should not be reflected as part of the financial position of the cemetery. Situations analogous to that of the cemetery include escrow funds held by an escrow company which are shown in a separate statement; trust funds established by third parties under which a college or university has a beneficial interest only in the resulting income, the trust corpus in such case not being included as an asset in the balance sheet of the college or university; and employees' pension, health, and welfare funds which are reflected in a separate statement.

Although the cemetery's balance sheet need not reflect the trust fund assets, the balance sheet should reflect the cemetery's agency obligation(s), i.e., the cemetery's liability either by contract or statute to pay over certain portions of monies received or receivable to the trustee.

The accounting treatment is the same whether the cemetery has entered into a contract to establish a trust or whether the cemetery's obligation to do so is required by statute.

Footnote disclosure of amounts held in trust, income from which is used in whole or in part to meet the cemetery's commitments respecting perpetual care, would be desirable but

not mandatory in order to make the statements not misleading (unless the statute itself calls for such disclosure). If footnote disclosure concerning the trust fund assets is made, the cemetery could also reiterate its policy or procedure of promptly remitting monies to the trustee in connection with cash and deferred payment transactions.

None of the AICPA's official Bulletins or Opinions have dealt specifically with the matter of accountability for, and presentation of, funds or property received by an accounting entity in various somewhat related capacities, i.e., as custodian, bailee, factor, depository, agent to receive and pay over, stockholder, or trustee. Technically, the trust funds are not required to be reported by any accounting entity other than the trust.

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➡ *The next page is 7431.* ←

## Section 7600

### ***Business Combinations*** **—General**

#### **.01 Date of Acquisition of a Company**

*Inquiry*—A corporation acquired a company for cash in March, subject to the same basic terms as negotiated orally in early January. It would like to designate December 31, the previous year-end of the acquired company, as the acquisition date, subject to imputed interest. The written contract does not specifically mention the date effective control passes to the acquiring company, although the December 31 balance sheet was prepared in accordance with Accounting Principles Board Opinion No. 16, paragraph 88(c) in anticipation of the acquisition.

Would it be proper to use December 31 of the previous year as the effective date of control of acquired company?

*Reply*—If the terms of the plan of combination were announced in writing or otherwise formally made known to the stockholders of the acquired company in early January, it would be appropriate to use, for accounting purposes, a balance sheet as of that date or any later balance sheet near the date of the cash payment with appropriate adjustment for imputed interest on the cash payment. If the December 31 balance sheet would not differ materially from a balance sheet prepared in early January, the December 31 balance sheet might be used.

Paragraph 93 of APB Opinion No. 16, states:

The Board believes that the date of acquisition of a company should ordinarily be the date assets are received and other assets are given or securities are issued. However, the parties may for convenience designate as the effective date the end of an accounting period between the dates a business combination is initiated and consummated.

Paragraph 46 of APB Opinion No. 16, states, in part:

A plan of combination is initiated on the earlier of (1) the date that the major terms of a plan, including the ratio of exchange of stock, are announced publicly or otherwise formally made known to the stockholders of any one of the combining companies (2) the date that stockholders of a combining company are notified in writing of an exchange offer.

It is assumed that there were no dividends, redemptions of stock, or other transactions between the acquired company and

its stockholders between December 31 and the date the assets were taken over by the purchaser. It is also assumed that the fair market value (rather than book value) of the assets of the acquired company, which must be determined in order to properly allocate the purchase price, did not change appreciably between December 31 and the date of initiation of the transaction.

## **.02 Date of Consummation of a Business Combination**

*Inquiry*—A client signed an agreement on June 30 for the acquisition of another company. The agreement calls for a closing date to be held only after the buyer receives financial statements of the seller for past years, and the seller receives a ruling from the Internal Revenue Service that the transaction will not be taxable. It is anticipated that these conditions will be met within sixty days of the signing of the agreement at which time stock will be exchanged.

The company's year ends on June 30, and the auditor is in the process of examining the financial statements of the client. The auditor believes that the two companies have effectively combined their interests as of the year-end. According to the requirements of Accounting Principles Board Opinion No. 16, paragraph 47g, was the combination consummated before the end of the client's fiscal year?

*Reply*—APB Opinion No. 16 does not define the term "consummated" as it is used in paragraph 47g. However, in that the two companies have effectively combined their interests before the end of the year, and the two conditions to the agreement were not major obstacles, paragraph 47g would not preclude the auditor from considering the transaction as consummated before the end of the year.

## **.03 Financial Statement Presentation of Agreement to Acquire Company**

*Inquiry*—A client has entered into an agreement to acquire fifty percent of the stock of a corporation. To finance the acquisition, the company has arranged for a third party, a bank, to acquire the fifty percent interest in the corporation, and the company will purchase these shares from the bank over a five-year period. The price to be paid the bank for these shares has been fixed, subject only to changes in the prevailing interest rates.

When the bank acquires the fifty percent ownership, the by-laws

of the corporation will be changed, and the client will be allowed to control half the seats of the board of directors.

Should the contract with the bank be considered an executory contract with the investment recorded only as the shares are acquired from the bank, or should the entire obligation be recorded on the client's financial statements?

*Reply*—The date of an acquisition in which the acquisition is being financed by an outside party depends primarily upon the date on which the principal rights of ownership are acquired. It would appear that the principal rights of ownership of equity securities are the rights to realize future gains in value and to be subject to future losses in value of the investee. Under the contract in question, the client has the right, subject to payment of the agreed amounts, to obtain the benefit of future earnings of the investee; and further, any losses in value of the purchased securities will be borne by the client. The principal attributes of ownership have been acquired by the company, and, therefore, the 50% interest and the related liability should be shown on the company's balance sheet.

#### **.04 Conditions for Pooling of Interests Method**

*Inquiry*—If any of the seven conditions set forth in paragraph 47 of Accounting Principles Board Opinion No. 16 are not met, a business combination must be treated as a purchase.

Condition “a” of this paragraph requires:

The combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.

Condition “g” requires:

The combination is resolved at the date the plan is consummated . . .

Is a combination resolved when a specific plan is initiated, completed, or consummated?

*Reply*—Paragraph 47(g) states that the existence of any provision for future issuance of stock or other compensation subsequent to the date a combination is consummated (based on market prices or earnings subsequent to consummation) would require that the combination be accounted for as a purchase. Paragraph 47(a) requires that the combination must be effected within one year following the initiation of the plan. The word “consummated” in subparagraph “g” should be read to include both

the phrase "effected in a single transaction" and "completed" as used in subparagraph "a".

This means that there may be conditions at the date of initiation of a plan as to the number of shares which may be issued. However, as long as these conditions are met by date of consummation of the plan and such date of consummation is not more than one year after the date of initiation, pooling of interest accounting is not precluded. The definition of consummation of a plan is discussed in Accounting Interpretation No. 4 of APB Opinion No. 16.

#### **.05 Accounting for Acquisition Costs Incurred in Merger**

*Inquiry*—In acquiring Corporation B, Corporation A incurred certain legal, accounting, printing, and other costs. These costs were capitalized and are being amortized over a forty-year period. Corporation B also incurred similar costs which were capitalized and are being amortized.

Consolidated financial statements are being prepared with the acquired Corporation B as an operating subsidiary of the acquiring Corporation A.

Were the merger costs properly handled, or should they be adjusted at this time?

*Reply*—Interpretation 33 of Accounting Principles Board Opinion No. 16 relates to costs of maintaining an "acquisitions department," and states:

All "internal" costs associated with a business combination are deducted as *incurred* in determining net income under APB Opinion No. 16. This answer applies to costs incurred for both "poolings" (see paragraph 58) and "purchases" (see paragraph 76). Naturally, costs incurred in unsuccessful negotiations are also deducted as incurred.

Paragraph 76 specifies that in a business combination accounted for by the purchase method the cost of a company acquired includes the *direct* costs of acquisition. These direct costs, however, are "out-of-pocket" or incremental costs rather than recurring internal costs which may be directly related to an acquisition. The direct costs which are capitalized in a purchase therefore include, for example, a finder's fee and fees paid to outside consultants for accounting, legal, or engineering investigations or for appraisals, etc. All costs related to effecting a pooling of interests, including the direct costs listed above, are charged to expense as specified in paragraph 58.

Costs of printing securities should reduce the fair value assigned to the securities, in accordance with paragraph 76 of APB Opinion No. 16.

The language in paragraph 76 and interpretation 33 indicates that the direct costs incurred by the acquiring corporation may be capitalized, but the costs incurred by the target (acquired) company may not. Therefore, the costs should have been expensed by Corporation B under APB Opinion No. 16. This should now be treated as a correction of an error under APB Opinion No. 20 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.

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➤➔ *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. Paragraph 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.

#### **.17 Business Combination with Contingent Consideration**

*Inquiry*—A corporation acquired all of the assets of another corporation under a contract of sale which provided that the buyer would pay to the seller:

- (a) Fifty percent of the after-tax profit of the buyer for ten years, and

- (b) Five cents for each unit of finished goods acquired by the buyer under the agreement, as and when they are sold by the buyer.

There were approximately eight million units of finished goods, but the contract stated that, for purposes of the agreement, the number of units was deemed to be six million. The seller's cost per unit was ten cents. Manufacture by the buyer continued, and, in order to avoid determination of whether the old or newly manufactured units were sold by the buyer, the agreement provided that the first six million units sold by the buyer would be the units sold under (b).

At the takeover date, the fixed assets had a fair market value of \$200,000 and a net book value on the seller's books of \$50,000. The finished goods had a book value of \$800,000, and the raw material and work in process had a net book value of \$25,000.

How should the acquisition be reflected on the books of the buyer?

*Reply*—Paragraph 78 of Accounting Principles Board Opinion No. 16 states in part:

The Board concludes that cash and other assets distributed and securities issued unconditionally and amounts of contingent consideration which are determinable at the date of acquisition should be included in determining the cost of an acquired company and recorded at that date.

To the extent that the contingent consideration is determinable beyond reasonable doubt, it should be included. If the existence of any after-tax profits for future years cannot be assumed beyond reasonable doubt, the consideration to be recorded currently should not exceed the fixed price of \$300,000.

Paragraph 91 of Opinion No. 16 provides that where the values of current assets, less liabilities assumed, exceeds the consideration paid, that the current assets be valued at fair value at date of acquisition, and that the excess of such value over cost should be classified as a deferred credit and amortized systematically to income over the period estimated to be benefited but not in excess of forty years.

The finished goods should be valued at estimated selling prices less the sum of (a) cost of disposal, and (b) a reasonable profit allowance for the selling effort of the acquiring corporation. The information furnished did not indicate whether this

would be more or less than \$800,000. Work in process should similarly be valued at selling price less costs to complete and sell the goods and less a reasonable profit. Raw materials should be valued at current replacement cost.

If the fair value of the inventories as determined above approximates the \$825,000 shown by the seller's books, the excess over cost might be \$475,000. As payments based on earnings of the buyer are received, an amount equal to 10% of \$475,000 (or \$47,500) in each year should be applied against the deferred credit. Any amount remaining should then be applied first to fixed assets until the undepreciated amount allocated to fixed assets is \$200,000. Any additional amounts received should be recorded as goodwill in accordance with paragraph 80 of APB Opinion No. 16. The fixed assets and the goodwill should be amortized over the remaining life of the respective assets which, in the case of goodwill, should not exceed forty years from the date of the purchase.

**.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, *Accounting for In-*

*tangible Assets.* Any excess of acquired net assets over cost should be accounted for in accordance with paragraph 91 of APB Opinion No. 16.

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➡ *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 SEC Accounting Series Releases Nos. 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.

#### **.17 Repurchase of Warrants Prior to Pooling of Interests**

*Inquiry*—One of the conditions for applying the pooling of interests method of accounting for business combinations is stated in paragraph 47b of Accounting Principles Board Opinion No. 16 as follows:

. . . 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 or debt securities of the other combining company. The issuing corporation may also distribute cash to holders of debt and equity securities that either are callable or redeemable and may retire those securities.

A corporation has outstanding warrants to purchase its voting common stock; the warrants expire at a fixed date in the future and are exercisable until then at a fixed price. If the corporation, following negotiations with the holder, repurchases the warrants for cash at the currently negotiated repurchase price, would such repurchase affect the corporation's ability to follow the pooling of interests method?

*Reply*—Paragraph 47b of APB Opinion No. 16 also states, "a corporation . . . may exchange substantially identical securities or voting common stock for other outstanding equity and debt securities of the other combining company." Therefore, if cash is

paid for the warrants, the conditions of paragraph 47b would not be met and the pooling of interests method could not be used to record the business combination. The corporation issuing the stock to effect the combination would have to exchange warrants or voting common stock for the presently outstanding warrants to meet the requirements of paragraph 47b.

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➡ *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*—Paragraph 53 of Accounting Principles Board Opinion No. 16, *Business Combinations*, 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 for that pooling of interests accounting would be appropriate. Based upon the above quotation, a sufficient amount should be transferred from the combined other contributed capital and then from the combined retained earnings in order to reflect A's capital at the number of shares outstanding times \$.10 per share.

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➡ *The next page is 7981.* ←



## Section 7910

### Subchapter 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 Subchapter S 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 a Subchapter S corporation to show a single balance sheet caption and amount for retained earnings?

*Reply*—A Subchapter S corporation may show a single balance sheet caption and amount provided the components of retained earnings (pre-election accumulations, previously taxed income, undistributed taxable income) are disclosed in the notes to the financial statements.

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➡ 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.

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**TIS Section 8000****AUDIT FIELD WORK**

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## 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.

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➡ *The next page is 8371.* ←





## Section 8200

### *Internal Control*

#### **.01 Study and Evaluation of Internal Control System**

*Inquiry*—Several small audit clients have weak internal control systems. If the auditor elects to not rely on the client's internal control, may he omit his study and evaluation of the internal control system? If the auditor does not rely on the client's internal control, is there any basis for restricting his audit procedures?

*Reply*—An auditor may not omit his study and evaluation of the client's internal control. The auditor may not have to conduct tests of compliance if he is not relying on the internal control, but the auditor must still study and evaluate the client's system of internal control as required by the second standard of field work.

Tests of compliance are meant to provide assurance that accounting procedures are being applied as prescribed and are discussed in Statement on Auditing Standards No. 1, beginning at section 320.55.

If an auditor does not rely on the client's internal control, he has no basis for restricting his audit procedures.

SAS No. 1, starting at section 320.69, contains a discussion of the correlation of the auditor's study of internal control with other auditing procedures, and section 330 of SAS No. 1 deals with evidential matter. The "substantive tests" referred to in the section on internal control relate to gathering evidence, and the third standard of field work is discussed in section 300. Where an auditor does not rely on the client's internal control, he must still obtain sufficient competent evidential matter to form the basis of his opinion. This is accomplished in part through the performance of "substantive tests."

#### **.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.

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➤➤➤ *The next page is 8471.* ➤➤➤

## Section 8210

### *Statistical Sampling*

#### **.01 Use of Block Sampling as a Test of Compliance**

*Inquiry*—Statement on Auditing Standards No. 1, section 320.61 states, “. . . tests of compliance . . . ideally should be applied to transactions executed throughout the period under audit because of the general sampling concepts that the items to be examined should be selected from the entire set of data to which the resulting conclusions are to be applied.” The opening sentence of section 320.62 indicates that either a subjective or statistical basis of selection may be used in connection with the tests of compliance. Do the above references preclude the use of block sampling as a test of compliance in examining recorded transactions?

*Reply*—The wording of the sections referred to would not rule out the use of block sampling in connection with tests of compliance. However, in keeping with SAS No. 1, section 320.61, the blocks should be representative of the entire set of data being tested.

#### **.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.

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➡ 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. 1, section 330, 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. (See SAS No. 1, sections 330.09-330.15.)

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➡ The next page is 8571. ←

## Section 8320

### ***Evidential Matter: Inventories***

#### **.01 Reliance on Observation of Inventories at an Interim Date**

*Inquiry*—Although its fiscal year ends on March 31, a client has always counted its physical inventory on December 31. The March 31 ending inventory has always been calculated by the gross profit method which has proven over the past to be quite accurate. No perpetual inventory records are kept.

Can the auditor rely on an observation of inventory that takes place three months prior to the balance sheet date?

*Reply*—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*—Section 901.28-.32 of Statement on Auditing Standards No. 1, deals with controls and auditing procedures for owner's goods stored in public warehouses. Section 901.32 provides that obtaining direct confirmation from the custodian is acceptable, except that "supplemental inquiries" are to be made 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.

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➡ *The next page is 8671.* ←



## Section 8330

### ***Evidential Matter: Fixed Assets***

#### **.01 Verification of Real Estate Ownership**

*Inquiry*—What procedures may be followed in the verification of real property accounts? Is it sufficient to examine the documents involved in the purchase of the property, to examine the real estate tax bills, and to communicate with the holders of any mortgages or trusts secured by the property? Should the client be required to assume the expense of a title search by an attorney?

*Reply*—It is generally conceded that examination of public records which contain the history of transactions relating to realty, as well as the current status of that property, is normally the function of an attorney or title company rather than that of an auditor. Accordingly if it is feasible for the client to obtain a letter from an attorney or title company which defines the interest the company holds in the land based upon a title search, this appears to be the best evidence available as to title and encumbrances.

If this procedure is too costly, then the following other audit procedures may supply sufficient indicia of title as to enable the auditor to assume that the client does, in fact, own the land subject to named liens.

1. Compare legal description of land found in deed with that found in the title insurance policy, abstract of deed, tax receipts, etc.
2. Verify current payment of carrying expenses of land in question, such as insurance premiums, tax payments, payments to mortgagee, etc.
3. Examine any rent receipts which may show evidence of continuing ownership.
4. Visit the land in question, if this is practicable.
5. Request an attorney's letter describing any conveyances or encumbrances of real property that may have been effected during the period covered in the audit, as well as his opinion regarding present status of title.

6. Obtain statement from client as to condition of title and encumbrance.
7. Check municipal or county records for evidence of ownership.

Use of a property map in connection with undertaking these procedures would also be helpful.

## **.02 Examination of Assets of a Rental Company**

*Inquiry*—A lessor is in the business of leasing autos, large trucks, tractors, and trailers. Is it necessary for the auditors to make physical observations of the rolling stock which is scattered across the country? What other audit procedures might be employed in the verification of this equipment? Must the titles to all equipment be examined?

*Reply*—It is not necessary, unless some extraordinary situation or circumstances were brought to light, to examine titles to all the equipment. Random test verifications of title certificates or proper registration of vehicles should be made. The fact that the client is receiving rent for the vehicles and is currently making payments on its time-purchase contracts would also be verified in regular course. Any tax and insurance payments which the client is required to make in connection with the vehicles can be checked. Also, test confirmations of possession of vehicles with the lessee should be made. Audit responsibility would not necessarily extend to physical observation of the equipment at its numerous shifting locations.

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➡ ➡ ➡ *The next page is 8731.* ⬅ ⬅ ⬅

## Section 8340

### **Evidential Matter: Confirmation Procedures**

#### **.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 Industry Audit Guide, *Audits of Brokers and Dealers in Securities*, 1973, states on page 112:

*Accounts Carried by other Brokers and Dealers in Commodities.*  
... Brokerage concerns with which such accounts are maintained should be requested to forward directly to the independent public accountant a statement of the account as of the audit date, showing the cash balance and the commodity positions “long” or “short.”

Does the above reference apply to an audit of a broker or dealer in commodity options?

*Reply*—The Audit Guide applies to a broker or dealer in commodity options. Therefore, the reference on page 112 should be followed in connection with the audit of a broker or dealer in commodity options.

**.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.

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»»→ *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 Statement on Auditing Standards No. 7. SAS No. 7 provides that a successor auditor make specific and reasonable inquiries of the predecessor auditor.

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**TIS Section 9000****AUDITORS' REPORTS**

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➡ *The next page is 9321.* ←

## Section 9110

### Compliance Reports

#### **.01 Auditors' Reports on Prescribed Report Forms—I**

*Inquiry*—Under state law, corporations must file a form with the State Corporation Commission which purports to be financial statements. The form, however, does not have provisions that will assure adequate disclosure of all the necessary facts. The form also contains a statement which must be signed by the preparer which may not express the usual responsibility assumed by a CPA in such matters. Also, there is no space on the form for the CPA's disclaimer of opinion if an audit has not been performed. How should a CPA protect himself on such unaudited "financial statements"?

*Reply*—Paragraph 21 of Statement on Auditing Standards No. 14 states in reference to such situations, "When a printed report form calls upon an independent auditor to make an assertion that he believes he is not justified in making, he should reword the form or attach a separate report."

On these forms, the CPA should type either an appropriate disclaimer or a reference such as, "See attached disclaimer of opinion." Such a disclaimer might read:

This report has not been audited by us and accordingly we do not express an opinion on it. It has been prepared on a prescribed form for use by the State Corporation Commission, and does not necessarily include all disclosures required for fair presentation of the financial position of the company in accordance with generally accepted accounting principles.

[Amended]

#### **.02 Auditors' Reports on Prescribed Report Forms—II**

*Inquiry*—A state's Medicaid reimbursement report contains the following statement which must be signed by the CPA preparing the report:

I hereby certify that this statement and accompanying schedules are true and correct to the best of my knowledge and belief.

Should the report be modified?

*Reply*—Statement on Auditing Standards No. 14 discusses prescribed report forms in paragraphs 20-21, and indicates:

Many of these forms are not acceptable to independent auditors because the prescribed form of auditor's report does not conform to the applicable professional reporting standards.

Some report forms can be made acceptable by inserting additional wording; others can be made acceptable only by complete revision. When a printed report form calls upon an independent auditor to make an assertion that he believes he is not justified in making, he should reword the form or attach a separate report.

If the information in the report is unaudited and the accountant is aware that his name will be associated with the report, the data should be marked as unaudited, and a disclaimer of opinion attached. (See SAS No. 1, section 516.10.) A Medicaid cost reimbursement report filed with a state would not come under the exclusion discussed in SAS No. 1, section 516.13 since it is not a tax return or other data being prepared solely for submission to a tax authority. [Amended]

#### **.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.

➡ 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. Paragraph 13 of Accounting Principles Board Opinion No. 20, 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."

Paragraph 7 of APB No. 20 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 paragraphs 17, 19, 20 and 21 of APB Opinion No. 20.

#### **.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-

puration 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 paragraph 6 of Accounting Principles Board Opinion No. 20 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 paragraphs 31 to 33 of APB Opinion No. 20.

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➡ *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.

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»»»→ *The next page is 9751.* ←«««

## Section 9320

### Uncertainties

#### **.01 Ability to Continue as Going Concern Doubtful**

*Inquiry*—Under which circumstances is it necessary for an auditor to question the client's ability to continue as a going concern? How would such doubts affect the auditor's opinion?

*Reply*—There are no specific guidelines to apply in determining if a company is no longer a going concern. However, some of the indicators might be as follows: (1) inability to meet current obligations as they come due, (2) a series of substantial losses and/or a significant deficit, (3) presence of other major contingencies which might result in substantial losses, (4) inability to meet the covenants of substantial loan agreements, and (5) inability to perform under existing contracts. In no way can these items be considered as all inclusive.

When the auditor believes the client cannot continue as a going concern, it is usually necessary for him to disclaim an opinion on the financial statements. The accountant's disclaimer of opinion does not state that the company is not a going concern; rather, the disclaimer states that the financial statements have been prepared on the basis of a going concern. The financial conditions which exist are then usually described with the accountant concluding that he is unable to express an opinion on the financial statements because of major uncertainty about the viability of the company.

#### **.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 artificially allocated over a period of years in order to avoid the tax surcharge for corporate income over \$25,000.

The parent corporation's auditors are uncertain how the potential tax liability should be disclosed in the financial statements. The revenue agent's report has not been issued regarding the civil liability for taxes pending resolution of criminal actions against the officers. Even though any decisions against the company are expected to be appealed, the auditors feel the taxes and

penalties assessed may be substantial—perhaps as much as half the consolidated net worth of the corporation.

How should this potential liability be disclosed in the financial statements when the auditors are uncertain as to the amount to be assessed?

*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, and the feeling that there is considerable uncertainty as to the outcome of the examination, the rule of informative disclosure requires that necessary explanation be made in a separate, middle paragraph of the auditor's report, similar in coverage to the following:

Tax returns filed by the company and its subsidiaries and affiliates covering the several fiscal years ending September 30, 19xx to 19xx inclusive, are being examined by the Internal Revenue Service. Informal indications are that charges based on section 482 of the Internal Revenue Code will be asserted against the company. Section 482 provides that where 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 such action is necessary to prevent evasion of taxes or to reflect the income clearly. No revenue agent's report has as yet been issued respecting any additional assessment for deficient taxes, and no estimated provision has been made in the financial statements covering liability for any contingent additional taxes.

The opinion paragraph could then read as follows:

Subject to the possible material effect on the financial statements of the above-mentioned tax examination, the outcome of which is uncertain, we do not express any opinion on the company's financial statements taken as a whole.

Based on the auditor's knowledge of the nature and validity of the charges to be made and the auditor's belief that the outcome of the tax matter may be adverse to the client, more is called for than brief disclosure to the effect that the years 19xx to 19xx are being examined and that no agent's report has been received as yet. Full and fair disclosure serves as a measure of self-protection since it puts readers of the financial statements on notice that further inquiry on their part may well be in order.

### **.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*—Paragraph 24 of Statement on Auditing Standards No. 2 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 paragraph 25 of SAS No. 2, 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.

**.04 Reliance on Legal Opinion Letter from Counsel Who Is Company Officer**

*Inquiry*—The legal counsel for a company is a 50 percent owner of the company and its chief executive officer. There are potential, material claims and contingencies to third parties and the other 50 percent owner of the company. In this situation, what reliance can be placed on a legal opinion letter from company counsel?

*Reply*—The letter from legal counsel should be considered essentially as representations contained in a management representation letter.

**.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 paragraphs 21-26 and 35 of Statement on Auditing Standards No. 2 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.

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➡ *The next page is 9851.* ←





## Section 9330

### **Subsequent Events**

#### **.01 Failure to Remit Withholding Taxes in Subsequent Period**

*Inquiry*—In the course of an examination of the financial statements, the auditor has discovered that in the period subsequent to the balance sheet date the company has not remitted to the appropriate agencies the taxes 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.

Therefore, unless such transactions might give evidence that the organization is in financial difficulties, disclosure of transactions in earlier statements would not usually be appropriate. On the other hand, the existence of financial difficulties might indicate that the going concern concept is no longer applicable. 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.

**.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.

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➤→ *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.

**.04 Issuance of Financial Statements Omitting Footnotes and Auditor's Opinion**

*Inquiry*—A client has requested a CPA to furnish financial statements to be given to certain suppliers. The CPA's name would not appear on the statements, and the notes to the financial statements and the auditor's opinion would not be included. These financial statements would be in addition to the CPA's regular long-form report which has an unqualified opinion. The client does not wish to furnish their suppliers with all the information contained in the notes to the statements but would like to use the CPA's typing and reproduction facilities to copy the statements.

How can the auditor convince the client that such "bare" financial statements cannot be provided?

*Reply*—The notes to the financial statements are an integral part of the financial statements under the Institute's requirement for adequate disclosure. It seems that if financial statements are presented without the notes to the financial statements, they would be misleading. Statement on Auditing Standards No. 1, section 516.07 indicates, "Further, a certified public accountant should refuse to provide typing or reproduction services or to be associated in any way with unaudited financial statements which, on the basis of facts known to him, he concludes are false or intended to mislead." The foregoing quotation applies equally as well to audited financial statements.

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➡ 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 does not cover only one basic financial statement, Statement on Auditing Standards No. 2,

paragraph 13, would not apply. 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."

Piecemeal opinions, precluded by paragraph 48 of SAS No. 2, are parenthetically defined as "expressions of opinion as to certain identified items in financial statements." Therefore, reporting under SAS No. 2, paragraph 5, would not constitute a piecemeal opinion.

If an opinion is disclaimed on the income statement, a disclaimer on the statement of changes in financial position would also be required.

#### **.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—I**

*Inquiry*—Often financial statements contain references such as:

“The accompanying notes form an integral part of this financial statement.”

or

“The accompanying notes and accountant's opinion form an integral part of this financial statement.”

The only difference between these two statements is the inclusion of the phrase, “and accountant's opinion.” Is such 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 auditor's opinion cannot form an integral part of the financial statements, and it is inappropriate to refer in such a manner to the auditor's report.

The only exception to this is when the accountant is not independent of his client. In such cases, Statement on Auditing Standards No. 1, section 517 requires the financial statements to include a reference to the accountant's disclaimer of opinion in which he indicates his lack of independence.

#### **.07 Reference in Financial Statements to Auditor's Report—II**

*Inquiry*—Would it be permissible to include a reference in the financial statements of a client directing the reader to the auditor's report when anything other than an unqualified opinion is presented? The reference would simply state, “See the report of the independent auditors on page X.”

*Reply*—Although such a reference is not commonly found in financial statements, a reference to the auditor's report would be acceptable under existing pronouncements if, in the auditor's judgment, its use is considered necessary in a particular case.

#### **.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.

Section 516.04 of Statement on Auditing Standards No. 1 shows an example of a disclaimer of opinion which states, "The accompanying [financial statements] . . . were not audited by us." Therefore, it would seem inconsistent to preclude the use of the terms "audit" and "audited" in the standard report.

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➡ The next page is 10,351. ←

## Section 9420

# Unaudited Financial Statements

### .01 Disclaimer of Opinion on Unaudited Balance Sheet Only

*Inquiry*—In addition to a complete set of interim unaudited financial statements, a CPA was asked to prepare a balance sheet to be attached to bids submitted by the client in connection with construction contracts. Since the income and retained earnings statements, and a statement summarizing the changes in financial position were omitted, the CPA suggested a report which indicates that the financial statements are incomplete. Is such a reference in the report necessary?

*Reply*—Paragraph 5 of Statement on Auditing Standards No. 2 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.

Paragraph 13 of SAS No. 2 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.

While SAS No. 2 applies only to audited financial statements, it nonetheless implies that it is not improper to report on separate financial statements. Thus, the disclaimer suggested in Section 516.04 of SAS No. 1 may be appropriately rephrased to cover the balance sheet only as follows:

The accompanying balance sheet of X Company as of December 31, 19\_\_ was not audited by us and accordingly we do not express an opinion on it.

### .02 Statement of Changes in Financial Position Omitted

*Inquiry*—In reporting on unaudited financial statements which do not include a statement of changes in financial position, would

the following disclaimer of opinion satisfy disclosure requirements?

I have not examined the accompanying balance sheet of XYZ as at December 31, 19xx and the related statement of income for the year then ended. Therefore, I do not express an opinion on them. No attempt has been made to assure that adequate disclosure as required by the pronouncements of the American Institute of CPAs has been made.

*Reply*—Reporting on unaudited financial statements is discussed in Statement on Auditing Standards No. 1, section 516. As indicated in SAS No. 1, section 516.06:

Because unaudited financial statements, by definition, have not been audited by the certified public accountant, he cannot be expected to have an opinion as to whether such statements have been prepared in conformity with generally accepted accounting principles. However, if the certified public accountant concludes on the basis of facts known to him that unaudited financial statements with which he may become associated are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should insist . . . upon appropriate revision; failing that, he should set forth his reservations in his disclaimer of opinion.

SAS 1, section 516.08 indicates, "the accountant is not required to prepare a statement of changes in financial position and include it in his accompanying report." If the financial statements are restricted to internal use by the client, the disclaimer should indicate that the statement of changes has been omitted. If the statements are not so restricted, the disclaimer should indicate that the financial statements do not conform to generally accepted accounting principles because the related statement of changes is not presented.

### **.03 Inadequate Disclosure in Unaudited Financial Statements**

*Inquiry*—A client has asked us to prepare his personal financial statements. Is it appropriate to include an adverse opinion on unaudited financial statements if there are departures from generally accepted accounting principles due to inadequate disclosure?

*Reply*—Since the financial statements are unaudited, it would not be appropriate to include an adverse opinion on the departures from generally accepted accounting principles. The departures from generally accepted accounting principles should be described in the report, but no reference should be made to an opinion concerning the departures.



**.04 Applicability of APB Opinion No. 22 to Unaudited Financial Statements**

*Inquiry*—Is the disclosure of accounting policies required by Accounting Principles Board Opinion No. 22 required on unaudited financial statements?

*Reply*—Statement on Auditing Standards No. 1, section 516.06 states in part, “. . . if the certified public accountant concludes on the basis of facts known to him that unaudited financial statements with which he may become associated are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should insist upon appropriate revision.”

Therefore, it appears the requirements of APB Opinion No. 22 apply to unaudited financial statements.

With regard to unaudited interim financial statements, paragraph 10 of Opinion No. 22 indicates that the requirements for disclosure of accounting policies are not intended to apply to unaudited financial statements issued as of a date between annual reporting dates (for example, each quarter), unless a reporting entity changes its accounting policies after the end of its preceding fiscal year. [Amended]

**.05 Unaudited Statements on Paper with CPA's Letterhead**

*Inquiry*—If a CPA is associated with a client's unaudited financial statements, and he includes the appropriate notices and disclaimer, would the typing of the statements on paper bearing the firm's letterhead create any problems, or is it preferable to always type unaudited statements on plain paper?

*Reply*—Section 516 of Statement on Auditing Standards No. 1 deals with unaudited financial statements. Section 516.03 states, in part, that association with the unaudited financial statements does not arise if the accountant, as an accommodation to his client, merely types on “plain paper” or reproduces unaudited financial statements so long as he has not prepared or otherwise assisted in preparing the statements and so long as he submits them only to his client. Once the CPA is associated with the unaudited statements, whether he uses “plain paper” or paper bearing his name will have no effect on his responsibility in the engagement.

**.06. Reference in Disclaimer to Possibly Incomplete Disclosure—I**

*Inquiry*—A disclaimer attached to unaudited financial statements includes the following sentence:

The financial statements presented are restricted to internal use only, and therefore do not necessarily include all disclosures that might be required for a fair presentation.

Is such a sentence appropriate?

*Reply*—Section 516.05 of Statement on Auditing Standards No. 1 deals with a CPA's association with unaudited financial statements when the statements are for the client's internal use only. If a CPA knows that third parties will rely on the unaudited financial statements, it is inappropriate to use the language in the above disclaimer. (Refer also to pages 25 through 28 of the AICPA Auditing Standards Division's *Guide for Engagements of CPAs to Prepare Unaudited Financial Statements* (1975).)

Auditing Interpretation No. 1 to SAS No. 1, section 516 deals with the circumstances under which a CPA's disclaimer of opinion on unaudited financial statements should refer to the absence of necessary disclosures and restriction of the statements to internal use. The interpretation states:

The notation of restriction to internal use and the possible lack of necessary disclosures should not be used when the CPA has knowledge that the client intends to distribute the report to third parties or in situations in which he believes distribution to third parties is likely. Paragraph .05 [of SAS No. 1, Section 516] applies only to statements which a client in fact is going to use only internally. Thus, if the client intends showing the statements to an outsider, the CPA should comply with Section 516.06 [of SAS No. 1], and insist upon including all necessary disclosures of which he has knowledge.

In those circumstances where internal use statements are issued, the accountant should clearly indicate the restrictions placed upon the use of the financial statements. The report might be worded as follows:

The accompanying financial statements were not audited by us and, accordingly, we do not express an opinion on them. Because these financial statements are issued solely for the internal information of the company's management, they do not necessarily include all disclosures that might otherwise be required. Therefore, they should not be referred to or presented to anyone outside the company for any purpose.

**.07 Reference in Disclaimer to Possibly Incomplete Disclosure—II**

*Inquiry*—For many clients, a CPA prepares monthly unaudited financial statements consisting of a balance sheet and a statement of earnings. Although the statements are generally for internal use only, the CPA is concerned that clients might give these statements to third parties, and as a consequence, he does not state in his transmittal letter that the statements are for internal use only. Instead, he states that “the statements are not prepared in accordance with generally accepted accounting principles, since a statement of changes in financial position is not presented and the statements do not include disclosures necessary for a fair presentation.”

Section 516.06 of Statement on Auditing Standards No. 1 states that if the CPA concludes the statements with which he is associated are not in conformity with generally accepted accounting principles and if the client is not willing for the CPA to spend the time to provide all of the required disclosure notes, the CPA should set forth clearly his reservations in his disclaimer of opinion. This section also states that the CPA should refer specifically to the nature of his reservations.

Does Section 516.06 mean that the CPA is required to list each specific account or area where disclosures are omitted, or is a general disclaimer sufficient?

*Reply*—The AICPA Auditing Standards Division *Guide for Engagements of CPAs to Prepare Unaudited Financial Statements* (1975) discusses this situation on pages 27 and 28:

Necessary disclosures should not be omitted when the CPA has reason to believe that the client intends to distribute the report to third parties. The application of section 516.05 is limited to statements that a client intends only for internal use.

A CPA should consider carefully the actions to take if he learns that his client has given restricted statements to a third party. Ordinarily, he should advise his client to revise the statements to include the omitted disclosures and to send the revised statements to all those who received the original ones. The CPA should determine that the previously omitted disclosures have been included before the revised statements are released.

Because of the problems that may be encountered when the internal use restriction is ignored, the CPA should exercise caution when engaged to prepare internal-use statements. If he knows that the client intends to distribute the statements to outsiders, the state-

ments should contain adequate disclosures; otherwise, the CPA should set forth his reservations in his report. If he is not certain of the client's intentions, but believes that it is likely that the statements will not be restricted to internal use he should insist that the statements be in conformity with generally accepted accounting principles following the prescriptions of sections 516.06 and .07 [of SAS No. 1].

In this situation, any reservations the CPA may have should be specifically spelled out because a generalized reference to lack of disclosure would not be enough.

#### **.08 Disclaimer of Opinion on Write-up Work—I**

*Inquiry*—A CPA firm does monthly write-up work by processing financial reports through its computer installation.

Each report page contains the note, "Prepared without independent audit verification." Also, a letter disclaiming an opinion is attached to each monthly report. Are both the footnote and letter necessary?

*Reply*—Since the CPA firm is preparing the financial statements in connection with the write-up work done for the clients, it would be associated with the unaudited financial statements (see section 516.03 of Statement on Auditing Standards No. 1). As indicated in section 516.04 of SAS No. 1, "A disclaimer of opinion should accompany the unaudited financial statements with which the certified public accountant is associated." Therefore, a disclaimer of opinion would be required for the monthly statements which are issued to the clients. The wording of the disclaimer should be as close as possible to the example contained in SAS No. 1, section 516.04. That section also indicates that the disclaimer of opinion may be placed directly on the unaudited financial statements.

Use of the phrase "prepared without independent audit verification . . ." on each page might be misconstrued to mean that some other type of audit verification has been made; the pages could simply be marked conspicuously as "unaudited."

#### **.09 Disclaimer of Opinion on Write-up Work—II**

*Inquiry*—The following letter is included with each monthly write-up financial report. Is the wording sufficiently detailed and clear as to the CPA firm's position?

The accompanying statements have been prepared by our staff with due professional diligence, according to the information available to us from your offices. However, our engagement was limited to accounting services only; therefore, we did not perform the necessary audit procedures, such as inventory observation, confirmation of receivables, and independent verification of all asset and equity accounts, that are prerequisites to an unqualified opinion as to the accuracy of the representations made in the financial statements.

Because of the limitations explained above, we do not express an opinion on the accompanying statement of financial condition and related statement of operations. We suggest that these statements be restricted to internal use since they may not include all disclosures that might be required for a fair presentation.

*Reply*—Statement on Auditing Standards No. 1, section 516.04 includes a suggested disclaimer of opinion for unaudited financial statements. Deviation from the suggested wording of the disclaimer indicated in section 516.04 may cause problems. For example, what does “with due professional diligence” in sentence one of the letter mean?

The second sentence indicates that “. . . we did not perform the necessary audit procedures such as inventory observation, confirmation of receivables, and independent verification of all asset and equity accounts. . . .” Such terminology and the remainder of that sentence might cause a reader to assume that the CPA is taking considerably more responsibility for the financial statements than he actually intends.

The disclaimer of opinion should not refer to scope limitations as implied in the second paragraph in the report.

Restricting the financial statements to the internal use of the client should not be permissive as indicated in the last sentence, “We suggest that these statements be restricted to internal use since they may not include all disclosures that might be required for a fair presentation.” The financial statements should either be restricted or not restricted. Reference should be made to SAS No. 1, section 516.05 for a discussion of reporting under these circumstances.

#### **.10 Disclaimer of Opinion on Write-up Work—III**

*Inquiry*—A member of an accountant’s staff proposes the following disclaimer in the accountant’s report because, although accounting services were performed, an audit was not part of the engagement:

The accompanying comparative balance sheets of \_\_\_\_\_ Corp., as of (date) and (date), the related comparative statement of income and retained earnings for the fiscal years then ended, and the statement of changes in financial position for the year ended (date), were prepared by (accounting firm's name) as an accounting service from the records provided by \_\_\_\_\_ Corp.

These statements were not audited by us, and we express no opinion on them.

Is this disclaimer proper for an engagement providing for write-up work and the preparation of unaudited financial statements?

*Reply*—Section 516.01 of Statement on Auditing Standards No. 1 indicates that a CPA may prepare unaudited financial statements and that “this type of engagement is an accounting service as distinguished from an examination of financial statements in accordance with generally accepted auditing standards.” It also states that “the statements are representations of management, and the fairness of their representation is management’s responsibility.” In addition, Interpretation of Rules of Conduct 101-3 of the Code of Professional Ethics (issued March, 1974), contains a further discussion of “accounting services.”

The example of a disclaimer shown in Section 516.04 of SAS No. 1 should be used wherever possible in reporting on unaudited financial statements. This will help avoid possibly misleading inferences in the disclaimer.

#### **.11 Computer-Prepared Trial Balances as Unaudited Financial Statements**

*Inquiry*—A CPA issues computer-prepared monthly financial statements to his clients, but he has found it difficult to present these statements in accordance with generally accepted accounting principles, particularly in regard to full disclosure, tax allocation, and classification of liabilities as long-term and current.

The CPA is considering substituting unaudited trial balances for the monthly financial statements. The trial balances would show the account balances of assets and liabilities and revenues and expenses, but they would not be as complete as financial statements. The trial balances would be for internal use only, and would include the appropriate disclaimer.

Would such a trial balance satisfy the requirements of section 516 of Statement on Auditing Standards No. 1?

*Reply*—A trial balance per se is not a financial statement but if the trial balance is presented in a form similar to financial statements and shows such items as total assets and total equities or total revenues and total expenses rather than just total debits and credits, it would be considered a financial statement within the definition on page 16 of the AICPA's Code of Professional Ethics (March 1, 1973). Financial statements are defined as, "Statements and footnotes related thereto that purport to show financial position which relates to a point in time or changes in financial position which relate to a period of time, and statements which use a cash or other incomplete basis of accounting. Balance sheets, statements of income, statements of retained earnings, statements of changes in financial position, and statements of changes in owners' equity are financial statements."

Since the statements are for the client's internal use only, the disclaimer of opinion should comply with section 516.05 of SAS No. 1 and each page of the statements should be clearly and conspicuously marked as unaudited.

## **.12 Association with EDP Produced Financial Statements**

*Inquiry*—A CPA who operates a data processing service bureau receives source information from clients which is processed by the CPA's data processing equipment and software to produce a general ledger, a journal summary, and financial statements in a predesigned format. The CPA only checks the data to make sure the accounts balance.

Is the CPA "associated" with these unaudited financial statements produced by the data processing equipment? Statement on Auditing Standards No. 1, section 516.03, states that a CPA is not associated with financial statements if he merely types or reproduces the statements on plain paper and does not assist in preparing them. Are these circumstances comparable?

*Reply*—In this situation, the CPA (1) has devised a required program, (2) checks the information furnished for a balanced condition, (3) operates the equipment, and (4) transmits the statements produced to the client. Such a procedure could not be considered mere reproduction on plain paper of financial statements prepared by the client. Therefore, the CPA's name is associated with the financial statements, and he must mark the statements as unaudited and disclaim an opinion on the statements.

If the software program was designed by someone other than the CPA, if it was selected and owned by the client, and if the input material was received from the client on punched card, tape or other acceptable machine input, operation of the hardware under the CPA's control and the production of the financial statements by him would not "associate" his name with such statements.

#### **.14 Unaudited Cash Basis Statements**

*Inquiry*—What amount of disclosure is necessary on unaudited cash basis financial statements, and what type of disclaimer of opinion is necessary?

*Reply*—The AICPA Auditing Standards Division *Guide for Engagements of CPAs to Prepare Unaudited Financial Statements* (1975) discusses cash basis unaudited statements on page 31:

A CPA may be engaged to prepare or assist in preparing unaudited statements on a cash basis. Since cash-basis statements ordinarily do not present financial position (balance sheet) and results of operations (income statement and statement of retained earnings), a statement of changes in financial position need not be included.

A disclaimer of opinion on cash-basis statements might be worded as follows:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 19xx, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and accordingly we do not express an opinion on them.

The cash-basis statements should disclose that they have been prepared on the basis of cash receipts and disbursements. If the CPA thinks that misleading inferences may be drawn from the statements, he should include an explanation in his disclaimer that the statements do not present financial position and results of operations. This might be accomplished by adding the following paragraph to his disclaimer:

Because of the omission of accounts receivable and accounts payable, the statements referred to above do not present the financial position or results of operations of the company.

#### **.15 Unaudited Financial Statements on Bank's Forms**

*Inquiry*—Several small businesses which do not keep their own books have been asked by a bank to submit financial statements



on forms provided by the bank. What is the CPA's responsibility in completing these forms for his client?

*Reply*—Section 516.03 of Statement on Auditing Standards No. 1 states:

A certified public accountant is associated with unaudited financial statements when he has consented to the use of his name in a report, document or written communication setting forth or containing the statements. Further, when a certified public accountant submits to his client or others, with or without a covering letter, unaudited financial statements which he has prepared or assisted in preparing, he is deemed to be associated with such statements. This association is deemed to exist even though the certified public accountant does not append his name to the financial statements or uses "plain paper" rather than his own stationery. However, association does not arise if the accountant, as an accommodation to his client, merely types on "plain paper" or reproduces unaudited financial statements so long as he has not prepared or otherwise assisted in preparing the statements and so long as he submits them only to his client.

If the forms submitted were indeed completed by the CPA, he should include on the form, or on an accompanying sheet, a disclaimer of opinion similar to that presented as an example in Section 516.04 of SAS No. 1.

#### **.16 Description of Audit Procedures in Letter to Management**

*Inquiry*—A firm performs engagements for several clients which involve limited audit procedures. Such procedures are not adequate to render either an unqualified opinion or a qualified opinion, due to the limitation on scope. However, the clients are often not happy with the standard disclaimer of opinion for unaudited financial statements because of the extent of procedures performed.

Would there be anything wrong with sending such clients a management letter setting forth the procedures performed? A disclaimer of opinion, as illustrated in Section 516.04 of Statement on Auditing Standards No. 1, would be issued on the financial statements.

*Reply*—Section 516.09 of Statement on Auditing Standards No. 1 indicates, "Any auditing procedures that may have been performed in connection with unaudited financial statements ordinarily should not be described in the accountant's report; to do so might cause the reader to believe that the financial state-

ments have been audited.” The disclaimer of opinion on the financial statements would be considered the “accountant’s report.” Therefore, setting forth the procedures performed in a management letter should specify that its distribution is restricted solely to the client.

#### **.17 Management Representation Letters**

*Inquiry*—During an engagement to prepare unaudited financial statements, an attorney representing the client questioned the CPA’s right to request a management representation letter. The attorney’s major objection was that the letter is a self-serving device which is not required for these engagements.

Is it a recommended procedure to request a management representation letter in engagements to prepare unaudited financial statements?

*Reply*—The AICPA’s *Guide for Engagements of CPAs to Prepare Unaudited Financial Statements* (1975) includes a list of suggested procedures which may be followed in such engagements. This list states on page 21, “At the completion of the engagement, some CPAs obtain from the client a letter acknowledging that the client accepts responsibility for the financial statements.” Management representation letters, however, are not required in engagements to prepare unaudited statements.

Perhaps some of the difficulty with the client’s attorney stems from a misunderstanding of what the representation letter is intended to accomplish. A representation letter generally confirms oral representations made by the client during the engagement, indicates and documents that such representations are still appropriate, and reduces the possibility of misunderstandings related to matters covered in the letter. Oral representations are ordinarily made by the client during an unaudited engagement as well as during an audit engagement. [Amended]

#### **.18 Marking Financial Statements as Unaudited**

*Inquiry*—Section 516.04 of Statement on Auditing Standards No. 1 requires that each page of unaudited financial statements be marked as such. Section 517.03 states that each page of the financial statements should be clearly and specifically marked, “Unaudited—see accompanying disclaimer of opinion.” Should the wording of section 517.03 be used on all unaudited financial

statements, or is it necessary only in those circumstances described in section 517?

*Reply*—Section 516.04 of SAS No. 1 states in part, “In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.” It is usual to place the word “Unaudited” in conspicuous type either directly above or below the title of the statement or directly over the column of figures.

Section 517.03, states in part, “Each page of the financial statements should clearly and conspicuously be marked ‘Unaudited—see accompanying disclaimer of opinion,’ unless the disclaimer of opinion appears thereon.” This is directed strictly toward reporting on financial statements when the auditor is not independent. There was no intention of modifying section 516.04.

#### **.19 Attachment of Disclaimer to Unaudited Financial Statements**

*Inquiry*—If the disclaimer of opinion is printed on each page of the financial statements, is it necessary to attach a letter of disclaimer to the financial statements?

*Reply*—In relation to disclaimers of opinion on unaudited financial statements, Statement on Auditing Standards No. 1, Section 516.04 states in part, “The disclaimer of opinion may accompany the unaudited financial statements, or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.” Under such circumstances a separate letter of disclaimer is not needed if the disclaimer appears on each page of the financial statements.

If the financial statements are not unaudited, but an opinion is disclaimed for other reasons, it would not generally be appropriate to present the disclaimer on each page of the financial statements.

#### **.21 Disclosure of Loan and Lease Agreements**

*Inquiry*—Is disclosure of loan and lease agreements required in unaudited financial statements?

*Reply*—The Auditing Standards Division has published a *Guide for Engagements of CPAs to Prepare Unaudited Financial Statements*. Pages 16 and 17 of the guide contain a discus-

sion of fair presentation in conformity with generally accepted accounting principles and state in part:

Since the CPA has not performed an audit, he cannot be expected to know whether the unaudited statements are in conformity with GAAP (which include adequate disclosure). However, he has extensive knowledge of GAAP and experience in their application, and he cannot close his eyes to financial statements that, on their face or on the basis of facts known to him, are not in conformity with such principles.

Although there is no requirement to examine lease agreements, or the terms of loans when the CPA is associated with unaudited financial statements, disclosure of this information should be made by the client as part of the client's representations.

## **.22 Tax Returns Submitted to Third Parties in Lieu of Financial Statements**

*Inquiry*—Does section 516 of Statement on Auditing Standards No. 1, Unaudited Financial Statements, apply to individual tax returns used by third parties in lieu of financial statements?

*Reply*—The AICPA *Guide for Engagements of CPAs to Prepare Unaudited Financial Statements* discusses on page 30 the applicability of section 516 to tax returns as follows:

Section 516.13 states the following:

This section does not apply to tax returns and other data prepared solely for submission to taxing authorities.

Consequently, when a CPA is engaged to prepare a tax return, and the return is prepared solely for submission to taxing authorities, section 516 does not apply and it is not necessary to append a disclaimer of opinion nor to mark the tax return as "unaudited."

Whenever a tax return is submitted to third parties in lieu of financial statements, the return would come under section 516 of SAS 1. A disclaimer of opinion would be necessary, and the tax return should be marked as "unaudited."

## **.23 Property Stated at Appraisal Value**

*Inquiry*—The unaudited balance sheet of a company shows property at appraised value. The cost of the property is not

**determinable. What is the wording of a disclaimer of opinion in that situation?**

*Reply*—Pages 24 and 25 of *Guide for Engagements of CPAs To Prepare Unaudited Financial Statements* show an example of a reservation for land recorded at appraisal values. An example of the wording to indicate that the cost is not determinable might read as follows:

Under generally accepted accounting principles, land is ordinarily stated at cost. Management has informed us that the company has recorded its land at appraised value. Since the cost is not determinable, the effect of the departure from generally accepted accounting principles cannot be quantified.

**.24 Computer-Prepared Financial Statements Issued to a Third Party**

*Inquiry*—Corporation A supplies information to a computer company for posting to the corporation's general ledger. The computer company prepares, for internal use only, monthly balance sheets and statements of income which a CPA firm reviews. At year end, the accounting firm prepares a trial balance and necessary closing adjustments which Corporation A gives to the computer company. The computer company then issues to Corporation A an annual balance sheet and statement of income which are unaudited and not accompanied by necessary footnote disclosures. Despite instructions to the contrary, Corporation A issues the computer-prepared financial statements to its bank without allowing the CPA firm to attach a disclaimer of opinion stating that the financial statements are unaudited and incomplete. Since the CPA firm prepares the closing adjustments, is the CPA firm associated with the computer-prepared financial statements? If so, what action should the CPA firm take when Corporation A sends such statements to the bank without a disclaimer of opinion that the statements are unaudited?

*Reply*—Pages 8 and 9 of *Guide for Engagements of CPAs to Prepare Unaudited Financial Statements*, which discuss computer-prepared financial statements, state:

The process by which financial statements are prepared does not alter the criteria for determining whether a CPA is associated with them. Therefore, the criteria for association established in section 516.03 (of Statement on Auditing Standards No. 1) apply to computer-prepared statements.

If the statements are processed on a computer controlled by the CPA, he is deemed to have prepared them and is associated with them. However, if the statements are processed by an independent computer service company, whether the CPA is associated with them depends on the circumstances. If the computer input data are prepared by the client and submitted by the client to an independent computer service company, and the processed financial statements are returned directly to the client, the CPA is obviously not associated. In addition, the CPA cannot be considered to be associated merely because the client consults with him on accounting or data-processing matters prior to submitting the data for processing. However, if, for example, the CPA prepared the computer input data, or receives the input data from the client and reviews it before it goes to the service company, he is associated with the resulting statements.

Since the CPA firm prepares adjusting entries to the year-end balances, the firm is associated with the computer-prepared financial statements.

The CPA firm should discuss the Guide and section 516 of *Statement on Auditing Standards No. 1* with Corporation A. The CPA firm should ask the client to send other financial statements to the bank. If Corporation A persists in issuing the computer-prepared financial statements to third parties without a disclaimer of opinion, the CPA firm should consider withdrawing from the engagement.

#### **.25 Disclosure of Related Party Transactions**

*Inquiry*—Do the disclosure requirements enumerated in paragraphs 16-18 of *Statement on Auditing Standards No. 6* apply to unaudited financial statements?

*Reply*—*Statement on Auditing Standards No. 6* does not directly apply to unaudited financial statements because paragraph 1 indicates the Statement provides guidance to the CPA performing an examination of financial statements in accordance with generally accepted auditing standards. Section 516 of *Statement on Auditing Standards No. 1* deals with unaudited financial statements. Section 516.06 indicates that adequate disclosure is necessary in unaudited financial statements, if information is known to the CPA. A CPA engaged to prepare, or assist in preparing, unaudited statements is not obliged to perform auditing procedures to determine the existence of, identity, or examine related party transactions. However, he should report known inadequacies in disclosure.

**.26 Operations Discontinued Subsequent to Balance Sheet Date**

*Inquiry*—A CPA is associated with unaudited financial statements of an enterprise that discontinued its operations subsequent to the date of the balance sheet. How should the CPA's disclaimer of opinion be worded?

*Reply*—A suitable disclaimer of opinion would be:

The accompanying statement of financial position of .....  
 ..... as of June 30, 1976, and the related  
 statements of earnings and retained earnings and changes in  
 financial position for the year then ended were not audited  
 by us, and accordingly we do not express an opinion on them.

Financial statements of entities that are presented in conformity with generally accepted accounting principles are prepared on a going-concern basis. However, the company discontinued operations in August 1976 as described in note 1. The amounts to be realized from the disposition of the assets and the amounts required to satisfy claims of creditors are not determinable at present.

The second paragraph in the above disclaimer may be included because the information is significant.

**.27 Financial Statements for Internal Use**

*Inquiry*—Does placing the words “unaudited—for internal use only” on financial statements constitute the expression of an opinion as required by the fourth standard of reporting?

*Reply*—The fourth standard of reporting states:

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed.

A disclaimer of opinion—not the word “unaudited”—is related to the part of the fourth standard of reporting which deals with the “assertion to the effect that an opinion cannot be expressed.” Accordingly, a disclaimer of opinion is needed in addition to the word “unaudited” on the financial statements. A CPA should disclaim an opinion on unaudited financial statements, in accordance with the language illustrated in section 516.04 of Statement on Auditing Standards No. 1. Further, if unaudited financial statements are for internal use and do not include all notes and other disclosures, the CPA should add to the disclaimer of opinion a sentence to the effect that the financial statements are restricted to internal use by the client and

therefore do not necessarily include all disclosures that might be required for a fair presentation in conformity with generally accepted accounting principles (section 516.05 of SAS 1).

### **.28 Buy-Sell Agreements**

*Inquiry*—Most buy-sell agreements include wording as to the accuracy of the financial information that the seller presents to the buyer.

Typical wording follows:

The financial statements attached hereto including, without limitation, the balance sheet at June 30, 19xx and the statement of income for the year then ended, have been prepared in accordance with generally accepted accounting principles consistently applied and fairly present the results of the operations of Company A during the respective periods covered thereby and the financial condition of Company A at the end of each such period.

If a CPA prepares unaudited financial statements as an attachment to a buy-sell agreement, what is his responsibility regarding the assertions in the buy-sell agreement?

*Reply*—The CPA is responsible for disclaiming an opinion on unaudited financial statements with which he is associated. The seller is responsible for his representations to the buyer.

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## 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.

**.04 Signing and Dating of Disclaimers on Unaudited Statements**

*Inquiry*—Is it necessary that the CPA's disclaimer of opinion accompanying unaudited financial statements be signed and dated, or is it sufficient to include a standard disclaimer imprinted in small type at the bottom of each page?

*Reply*—A disclaimer of opinion is a form of accountants' report which should be signed and dated just as other accountants' reports should be signed and dated. Section 516.04 of Statement on Auditing Standards No. 1 clearly indicates this. The signing and dating of a disclaimer is for the accountant's own protection and it also supplies the reader of the financial statements with information as to who prepared the financial statements, and when. There is no objection to the use of a standard printed form of disclaimer or a rubber stamp if regular size type is used and the disclaimer is signed and dated. The printed firm name can suffice for a signature provided that the date is added after the name.

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## 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.

#### **.04 Special Report on Inventory**

*Inquiry*—An accountant prepares unaudited financial statements for a client. The terms of a loan agreement specify that the accountant is to furnish the bank an opinion on the client's inventory. Can the accountant issue a special report on inventory and disclaim an opinion on the unaudited financial statements?

*Reply*—The accountant can issue a special report on the client's inventory, disclaim an opinion on the unaudited financial statements, but he should evaluate carefully whether an opinion on the inventory can be expressed without examining the financial statements.

In accordance with section 516.09 of Statement on Auditing Standards No. 1, any auditing procedures that have been performed in connection with the special report should not be described in the auditor's report on the unaudited financial statements, since to do so might cause the reader to believe that the data was audited.

See also Statement on Auditing Standards No.14, paragraphs 9-17. [Amended]

#### **.05 Financial Statements Prepared on Liquidation Basis**

*Inquiry*—Company A is in the process of liquidating and dissolving with approval of the stockholders. What language should an auditor use in reporting on financial statements for a company being liquidated?

*Reply*—A liquidation basis of accounting is a comprehensive basis of accounting other than generally accepted accounting principles. An auditor reporting on liquidation basis financial statements should follow the guidance in paragraph 5 of Statement on Auditing Standards No. 14. The following is an illustration of an auditor's report on financial statements prepared in accordance with a liquidation basis of accounting:

We have examined the statement of assets and liabilities of XYZ Company (in liquidation) as of December 31, 19xx, and the related statement of revenues and expenses

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.

Shareholders of XYZ Company voted on April 15, 19xx to liquidate, and the Company commenced liquidation shortly thereafter. The Company's present policy, as described in Note X, is to prepare its financial statements on the basis of estimated realizable amounts; accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly the assets and liabilities of XYZ Company (in liquidation) as of December 31, 19xx, and the revenues and expenses for the year then ended, on the basis of accounting described in Note X, which basis is different from that of the preceding year as described in Note X.

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**➡ The next page is 10,851. ⬅**



## Section 9520

### **Reliance on Others**

#### **.01 Definition of "Principal Auditor"**

*Inquiry*—In the situation where one auditor relies on the work of another auditor, the term "principal auditor" is used. How is the term "principal auditor" defined?

*Reply*—The "principal auditor" is the auditor expressing an opinion on the financial statements of the parent company or on the consolidated financial statements of several companies, while the "other independent auditor" expresses an opinion on the financial statements of a subsidiary, division, or branch whose statements are being incorporated therein. The term "primary auditor" is also used in this connection as the equivalent of "principal auditor."

#### **.02 Responsibility for Audit of Dividend Fund Managed by Agent**

*Inquiry*—A mutual fund employs a management company to act as its dividend disbursing agent and transfer agent. Dividend checks to the individual shareholders of the mutual fund are drawn from a "dividend disbursing agency fund." This account, however, does not appear as an asset or liability on the books of either the mutual fund or the management company.

Is it the responsibility of the mutual fund's auditors or the management company's auditors to audit the dividend disbursing agency fund?

*Reply*—Since it is one of the primary responsibilities of the management company for the mutual fund, to draw and pay individual dividend checks to the fund's shareholders, it would be appropriate for, if not incumbent upon, the management company's auditors, in connection with their audit, to see that this function is being properly discharged, even though the account from which these checks are disbursed does not appear as an asset or liability on the books of either the fund or the management company.

**.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*—Auditing Interpretation No. 1, "Alternative Procedures for Observation of Physical Inventories," section 9509.01-.06 of *AICPA Professional Standards*, Volume 1, 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.

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## 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.

### **.03 Auditor's Report when Receivables Not Confirmed and Inventories Not Observed**

*Inquiry*—In some engagements with longtime clients, a CPA has completed all the appropriate auditing procedures except for the observation of inventories and the confirmation of receivables. The CPA feels these steps are unnecessary because of his knowledge of the clients and because of their continuing relationship.

Because inventories are not observed and receivables are not

confirmed, is it necessary for the auditor to disclaim an opinion on the financial statements and mark each page as “unaudited”?

*Reply*—Statement on Auditing Standards No. 1, section 516.02 states:

Financial statements are unaudited if the certified public accountant (a) has not applied any auditing procedures to them or (b) has not applied auditing procedures which are sufficient to permit him to express an opinion concerning them. . . . The certified public accountant has no responsibility to apply any auditing procedures to unaudited financial statements.

On the other hand, SAS No. 2, paragraph 45 states:

The disclaimer of opinion is appropriate when the auditor has not performed an examination sufficient in scope to enable him to form an opinion on the financial statements. . . .

If the only auditing procedures omitted are observation of physical inventory and correspondence with trade debtors, the financial statements are not “unaudited” and it would be inappropriate to so state.

#### **.05 Wording of Auditor's Disclaimer Specifying Scope Limitations**

*Inquiry*—Does the following opinion properly detail the limited extent of examination and disclaimer of opinion?

In accordance with your instructions, we have examined the books and records of (name of client) as at (date of statement) and for the year then ended. As a result of our examination, the following statements are submitted herewith:

Exhibit “A”—Balance Sheet  
As at (Date)

Exhibit “B”—(Name)

The primary purpose of our engagement was to assemble the necessary information to prepare the tax returns. Although certain auditing procedures were employed, the scope of our examination was limited. Therefore, we cannot and do not express an opinion on the overall representations in the attached statements.

*Reply*—“In accordance with your instructions” infers that the scope limitations are client imposed. Use of the phrases “we have examined” and “as a result of our examination” indicates that the statements submitted were audited. The exhibits listed don’t clearly show whether all the basic financial statements are presented.

Statement on Auditing Standards No. 2, paragraph 46 indicates that with respect to significant scope limitations, the procedures omitted should be recited. The sentence, "Although certain auditing procedures were employed, the scope of our examination was limited," attempts to do this but it is not specific enough. Rather than the phrase "on the overall representations in the attached statements," the terminology used in SAS No. 2, paragraph 47 "on the financial statements" should be used.

If the financial statements submitted are, in fact, simply a by-product of an engagement to prepare tax returns, they should be reported upon as indicated in SAS No. 1, section 516. Adding the sentence, "The primary purpose of our engagement was to prepare the tax returns," to the disclaimer shown in SAS No. 1, section 516.04 would be acceptable. If, however, the statements are audited, the auditor should treat this as a limited scope engagement and report in accordance with SAS No. 2, paragraphs 40 and 45-47.

#### **.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



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.

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## Section 9550

### Long-Form Reports

#### **.01 Separate Long-form and Short-form Reports for the Same Period**

*Inquiry*—A CPA's long-form audit report issued on a client's balance sheet, income statement, statement of retained earnings, and statement of changes in financial position was sent to the stockholders. The client now wishes to present only the balance sheet along with a short-form auditor's report in a newspaper advertisement.

Would it be proper to present the short-form audit report instead of the long-form report, and would it be proper to issue the short-form report on the balance sheet only?

*Reply*—There is always the danger when both a short-form and a long-form report are prepared to cover the same financial statements that some individual might claim that he relied improperly on the short-form report because the long-form report included additional material necessary for a fair presentation. However, if the auditor has carefully considered the danger and is satisfied that no such claim can properly be made, there is no objection to the issuance and publication of a short-form report. Also, there is no objection to issuing a report on a balance sheet alone as long as the report includes all matters covered in the long-form report that are necessary for a fair presentation of financial position.

#### **.02 Listing Audit Procedures Followed in Long-form Report with Disclaimer Due to Scope Limitation**

*Inquiry*—A CPA firm will issue a long-form report which contains a disclaimer of opinion because of a significant scope limitation, namely the observation of physical inventory. Would it be permissible to list certain other auditing procedures performed such as confirmation of receivables or verification of fixed asset additions?

*Reply*—Statement on Auditing Standards No. 1, section 610, deals with long-form reports. Section 610.06 states in part, "... the auditor should prepare the long-form report in a manner

that makes it clear that he is expressing therein the same type of professional opinion as in a short-form report."

Since the scope limitation which has led to the disclaimer of opinion applies equally to short-form and long-form reports, in accordance with paragraph 46 of Statement on Auditing Standards No. 2, the auditing procedures performed should not be listed in the long-form report.

### **.03 Reporting on Supplementary Financial Information**

*Inquiry*—If supplementary financial information (for example, details of operating expenses, details of other income, and historical financial highlight summaries) is presented in a long-form report in addition to the basic financial statements, does section 610.02 of Statement on Auditing Standards No. 1 require that an auditor express an opinion on the supplementary financial information?

*Reply*—Section 610 of SAS No. 1 deals with long-form reports. Section 610.01 states:

In addition to the basic financial statements, these [long-form] reports ordinarily include details of the items in these statements, statistical data, explanatory comments, other informative material, some of which may be of a nonaccounting nature, and sometimes a description of the scope of the auditor's examination more detailed than the description in the usual short-form reports.

In accordance with section 610.02, the responsibility the auditor is taking, if any, regarding the supplementary financial information should either be specifically covered in a separate report in the long-form report, or in a separate paragraph(s) added to the standard report.

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## Section 9900

### Other Reporting Problems

#### **.01 Unauthorized Removal of Auditors' Disclaimer**

*Inquiry*—Because of the lack of proper internal and accounting controls, a CPA firm was unable to express an opinion on a client's financial statements and stated this in the accountant's report. The company is for sale and the CPA has been told his report will be removed from copies of the company's financial statements used for the purpose of selling the company. The CPA firm has sent a letter to the company that this is not acceptable. What other steps should be taken?

*Reply*—Statement on Auditing Standards No. 1, section 561, although not directly applicable to this situation, in some respects parallels it.

Unless the CPA's attorney recommends otherwise, the CPA might notify each bank operating in the area and any others known by the auditor to be relying on the incomplete financial statements that any financial statements on his stationery should be considered only in light of the opinion or disclaimer of opinion accompanying such statements and that, if there is not such an accompanying opinion, the CPA would wish to be notified.

#### **.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*—As specified in Paragraph 13 of Statement on Auditing Standards No. 15, an auditor's report discloses 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.

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TIS

## APPENDIXES

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References cited in the Technical Information Service Inquiries and Replies are cross-indexed to sections in the text

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➡ *The next page is 15,011.* ←



# AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

## Accounting Research Bulletins

No.	Chap.	Par.	Sec.	No.	Chap.	Par.	Sec.
43	Intro.	5	1300.07	43	7B	10	4150.02
	Intro.	5	6120.02		7B	10	4150.03
	1B		4120.02		7B	12	4150.01
	2A	2	1100.01		7B	12	4150.03
	3A		2240.05		7B	13	4150.02
	3A	4	2120.03		11A	13	6700.05
	3A	4	2130.02		11A	16	6700.05
	3A	6	2120.01		11A	17	6700.05
	3A	6	2240.01		11A	18	6700.05
	3A	7	2240.01		12	8	1400.01
	3A	9	2120.03		13B	12	4140.05
	4		6700.08	45			6700.04
	4	3	2140.03			1	6700.05
	4	3	2140.04			6	5260.01
	4	5	2140.01			11	5260.01
	4	5	6700.04			12	6700.09
	4	6	2140.09			15	6700.07
	4	7	2140.09	46			4220.02
	4	8	7300.12	51			6400.02
	4	9	7300.12			1	1400.01
	4	11	3500.04			2	1400.01
	4	16	2140.06			2	1400.15
	4	16	2140.08			6	1400.08
	4	17	3500.04			6	1400.09
	5	4	2250.04			6	1400.11
	7A		4220.02			17	1400.08
	7A		4220.03			22	1400.06
	7A	2	4220.01			24	9410.05
	7A	9	4220.03				
	7B	10	4150.01				

➡ The next page is 15,021. ⬅



**Accounting Principles Board Opinions**

No.	Par.	Sec.	No.	Par.	Sec.
2			14	16	4130.02
(Addendum)		5240.05		18	4130.01
	2	6200.01			
	2	6200.03	15	6	5500.02
	3	6200.03		22	5500.14
	4	6200.03		23	5500.14
	5	6200.03		36	5500.09
6		6610.08		36	5500.11
	12	4120.02		36	5500.12
	17	2250.04		37	5500.09
	17	4220.01		38	5500.09
8	26	5230.04		38	5500.14
	27	5230.03		38	5500.16
	27	5230.04		40	5500.14
	28	5230.04		48	5500.15
	29	5230.04		50	5500.07
	30	5230.03		51	5500.09
	30	5230.04		52	5500.09
	31	5230.04		53	5500.09
	32	5230.04		57	5500.12
	41	5230.07		58	5500.09
10		6600.05		62	5500.05
	7	2240.01		64	5500.05
11		2130.04		65	5500.10
		5250.01		70	4210.02
		5400.03			
		6100.03	16		5250.06
	13	6100.04		5	7610.18
	13	7200.03		5	7620.04
	41	5250.10		5	7620.05
	49	5250.06		5	7620.06
	57	2130.02		5	7620.07
	57	5250.02		5	7620.08
	61	5250.05		5	7620.12
	63	9310.02		43	7610.18
Appendix A (D)		5210.02		43	7620.06
12		5210.02		46	7600.01
	5	9410.03		46	7620.09
	6	5230.06			
	7	5230.06			
	8	5230.06			

**Accounting Principles Board Opinions—(Cont'd)**

No.	Par.	Sec.	No.	Par.	Sec.
16	46	7620.10	16	91	7610.17
	47	7600.02		91	7610.18
	47	7600.04		92	7610.09
	47	7620.05		93	7610.01
	47	7620.10		93	7610.02
	47	7620.11		94	7610.02
	47	7620.13		99	7620.01
	47	7620.14			
	47	7620.16	17		6200.03
	47	7620.17			7610.04
	47	7630.01			7610.05
	48	7620.15			7610.18
	53	7630.02		22	2210.13
	58	7600.05		24	2250.01
	66	7610.06		24	4110.02
	67	7610.15		24	4110.04
	68	7610.09		25	2250.04
	68	7610.15		25	4110.02
	76	7600.05		26	4110.02
	78	7610.17		27	2250.03
	80	2250.02		27	7610.06
	80	7610.17		28	2250.01
	87	7610.06		28	7610.06
	87	7610.07		29	2250.01
	87	7610.09		29	2250.03
	87	7610.13		29	7610.06
	88	2220.08		30	2250.02
	88	7600.01		30	7610.06
	88	7610.06		31	2250.02
	88	7610.07		31	3200.06
	88	7610.08		31	7610.06
	88	7610.09		32	2250.03
	88	7610.10			
	88	7610.12	18	2	1600.02
	88	7610.15		2	2220.07
	89	7610.06		2	7300.05
	89	7610.07		3	1600.03
	89	7610.09		3	2220.03
	89	7610.12		4	1400.01
	90	7610.09		14	1400.01
	91	7610.07		14	1400.05
	91	7610.08		14	1400.14
	91	7610.09		14	7610.06

**Accounting Principles Board Opinions—(Cont'd)**

No.	Par.	Sec.	No.	Par.	Sec.
18	14	9410.05	20	19	9210.05
	17	2220.01		20	1300.08
	17	7300.05		20	5210.01
	17	7620.03		20	9210.05
	19	1400.09		21	5210.01
	19	2220.05		21	9210.05
	19	2220.08		22	5210.01
	19	2220.10		24	5210.01
	19	2220.11		29	9210.02
	19	7920.01		31	2250.02
19		1300.01		31	6400.09
		6610.02		31	9210.08
	7	1300.03		32	6400.09
	7	1300.05		32	9210.08
	7	1300.07		33	6400.09
	8	1300.02		33	9210.08
	10	1300.06		36	7300.12
	10	1300.08		37	7300.12
	12	1300.02	21		3200.06
	12	1300.04			6960.05
	14	1300.09		3	5220.04
	15	1300.02		3	6130.01
20		1200.03		15	5220.05
		2240.04		16	3200.01
		3200.06		16	3200.02
		6130.07		16	3200.03
		7600.05		16	3200.04
		9210.03		16	6130.01
		9210.04	22		9420.04
	6	9210.08		8	6935.01
	7	9210.05		10	9420.04
	10	6400.09	23	2	5250.10
	10	9210.08		12	7920.01
	11	6400.09		23	6100.03
	11	9210.08		23	9210.06
	13	7300.12	24		1600.03
	13	9210.05	25	10	4140.01
	16	2140.10		10	4140.02
	17	2140.10		13	4140.01
	17	9210.05		20	4140.04
	18	9210.01	26		3200.06
	19	5210.01			

**Accounting Principles Board Opinions—(Cont'd)**

<b>No.</b>	<b>Par.</b>	<b>Sec.</b>	<b>No.</b>	<b>Par.</b>	<b>Sec.</b>
29	3	7300.07	30	20	5400.01
	18	2210.11		20	5400.02
	18	5100.26		20	6100.06
	21	6600.07		20	6400.09
30		5250.05		21	5400.02
	8	1200.02		21	6400.09
	10	5400.03		22	5400.02
	11	5400.03		22	6400.09
	12	5400.03		23	2250.05
	13	1200.02		23	5400.03
	13	5400.01		23	6400.09
	14	7920.01		26	2250.05
	19	5400.02		26	4110.04
	19	6400.09		26	5400.01
	20	4110.04		26	5400.02
				26	6100.06

➡ The next page is 15,031. ←



**Accounting Principles Board Statements**

<b>No.</b>	<b>Par.</b>	<b>Sec.</b>	<b>No.</b>	<b>Par.</b>	<b>Sec.</b>
4	148	5100.12	4	151	5100.23
	148	5100.14		151	5100.27
	148	5100.16		151	6600.01
	149	5100.12		152	5100.12
	149	5100.14		152	5100.14
	150	5100.12		152	5100.23
	150	5100.14		152	5100.27
	150	5100.23		153	3600.01
	150	5100.25		153	5100.12
	150	5100.27		153	5100.14
	150	6600.01		153	5100.23
	151	5100.09		153	5100.27
	151	5100.12		159	2210.15
	151	5100.14		194	6700.01
				198	1100.04

➡ 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	26	7610.18
11	11	5250.03		30	7620.13
	16	5250.06		33	6410.03
12	1	2240.05		33	7600.05
15	Introduction	5500.09		39	7620.03
	10	5500.16		39	7620.04
	21	5500.07		39	7620.05
	25	5500.08		39	7620.06
	64	5500.03		39	7620.07
	80	5500.03		39	7620.12
	91	5500.05	18	1	2220.08
16	4	7600.04		1	2220.10
	14	7620.13		2	1400.03
	20	7610.01		2	2220.05
	20	7620.11		2	2220.11
	20	7620.16	30	1	1200.02
	21	7620.15			

➡ The next page is 15,051. ⬅



**Accounting Research Studies**

No.	Page	Sec.	No.	Page	Sec.
7	257	1100.06	15		4220.02
8	134	5230.04		43-44	6100.07
	135	5230.04		67-68	4230.01

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➡ The next page is 15,061. ⬅



**Industry Accounting Guides**

<b>Name of Guide</b>	<b>Sec.</b>	<b>Name of Guide</b>	<b>Sec.</b>
<i>Accounting for Franchise</i>		<i>Accounting for Retail Land</i>	
<i>Fee Revenue</i>	6940.01	<i>Sales</i>	6610.01
<i>Accounting for Motion Picture</i>			6610.02
<i>Films</i>	6970.01		6610.03
<i>Accounting for Profit Recogni-</i>			6610.04
<i>tion on Sales of Real Estate</i>	3200.07		6610.05
	5100.12		6610.06
	6600.02		6610.08
	6600.03		6610.09
	6600.04		6610.10
	6600.05		6610.11
	6600.06		6610.12
	6600.08		6610.13
	6610.01		6610.14
	6610.14		

➡ The next page is 15,065. ⬅





**Statements of Position**

No.	Title	Sec.
74-6	<i>Recognition of Profit on Sales of Receivables with Recourse</i>	2130.04

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**➡ The next page is 15,071. ←**



**Statements on Auditing Standards**

No.	Sec.	Par.	Sec.	No.	Sec.	Par.	Sec.
1	110	.02	9410.06	1	331	.13	8320.05
	300		8200.01			.14	8320.05
	320	.55	8200.01			.15	8320.05
		.61	8210.01		332	.05	2220.11
		.62	8210.01		420		9210.04
		.69	8200.01			.06	5210.01
	330		8200.01		516		9420.22
		.09	8310.02				9420.24
		.10	8310.02			.01	9420.25
		.11	8310.02			.02	9420.10
		.12	8310.02			.03	9530.03
		.13	8310.02			.03	9420.05
		.14	8310.02			.03	9420.08
		.15	8310.02			.03	9420.12
	331	.01	8320.02			.03	9420.15
		.02	8320.02			.04	9410.10
		.03	8320.02			.04	9420.01
		.03	8340.01			.04	9420.08
		.04	8320.02			.04	9420.09
		.04	8340.01			.04	9420.10
		.05	8320.02			.04	9420.15
		.05	8340.01			.04	9420.16
		.06	8320.02			.04	9420.18
		.06	8340.01			.04	9420.19
		.07	8320.02			.04	9420.27
		.07	8340.01			.04	9430.04
		.08	8320.02			.04	9430.05
		.08	8340.01			.05	9420.06
		.09	2140.02			.05	9420.07
		.09	8320.01			.05	9420.09
		.09	8320.02			.05	9420.11
		.09	8320.05			.05	9420.27
		.10	2140.02			.06	9420.02
		.10	8320.01			.06	9420.04
		.10	8320.05			.06	9420.06
		.11	2140.02			.06	9420.07
		.11	8320.01			.06	9420.07
		.11	8320.05			.06	9420.25
		.12	2140.02			.07	9390.04
		.12	8320.01			.07	9420.07
		.12	8320.05			.08	9420.02
		.12	9530.06			.09	9420.16
		.13	2140.02			.09	9510.04
						.10	9110.02
						.13	9110.02
						.13	9420.22

**Statements on Auditing Standards—(Cont'd)**

No.	Sec.	Par.	Sec.	No.	Sec.	Par.	Sec.
1	517	.03	9420.18	2		23	9320.05
	530	.01	9430.03			24	6400.08
	543		9510.03			24	9320.03
	546	.15	9530.07			24	9320.05
	560	.03	3100.04			25	6400.08
		.03	9330.01			25	9320.03
		.03	9330.03			25	9320.05
		.04	9330.03			26	9320.05
		.05	9330.01			35	9320.05
		.07	9330.02			40	9530.05
		.12	9430.03			40	9530.08
	561		9900.01			45	9310.01
	610	.01	9550.03			45	9530.03
		.02	9550.03			45	9530.05
		.06	9550.02			46	9530.01
	901	.28	8320.06			46	9530.05
		.29	8320.06			46	9530.08
		.30	8320.06			46	9550.02
		.31	8320.06			47	9530.01
		.32	8320.06			47	9530.02
2			2210.09			47	9530.05
		5	1100.01			47	9530.08
		5	9410.03	6		48	9410.04
		5	9410.04				7400.04
		5	9420.01				7400.05
		7	9410.09			1	9420.25
		10	8320.02			3	7400.04
		10	9530.01			16	9420.25
		10	9530.07			17	9420.25
		11	8320.02	7		18	9420.25
		11	9530.01	9		7	8900.02
		11	9530.06			11	9520.03
		12	8320.02	12			9520.03
		12	8340.02	14			8340.09
		12	9530.01				6120.01
		12	9530.06			4	1500.03
		13	1100.01			5	9510.05
		13	8320.02			8	6950.03
		13	9410.03			9	9510.04
		13	9410.04			10	9510.04
		13	9420.01			11	9510.04
		13	9530.01			12	9510.04
		21	9320.05			13	9510.04
		22	9320.05			14	9510.04
		23	6400.08			15	9510.04
						16	9510.04
						17	9510.04

**Statements on Auditing Standards—(Cont'd)**

No.	Sec.	Par.	Sec.	No.	Sec.	Par.	Sec.
14		20	9110.02	15		2	9430.01
		21	9110.01			13	9900.03
		21	9110.02				

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➡ The next page is 15,081. ←



**Auditing Interpretations of Statements on Auditing Standards**

Auditing Interpretation AU Sec.*	TIS Sec.
9509.01-.06	9520.04
9516.01-.03	9420.06

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➡ *The next page is 15,091.* ←

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\* See Volume 1, *AICPA Professional Standards*.





**Industry Audit Guides**

<b>Name of Guide</b>	<b>Sec.</b>	<b>Name of Guide</b>	<b>Sec.</b>
<i>Audits of Banks</i>	6100.02	<i>Audits of Investment Companies</i>	
	6100.03		6910.01
	6100.04		6910.02
	6100.07		6910.03
<i>Audits of Brokers and Dealers in Securities</i>	1100.02	<i>Audits of Personal Financial Statements</i>	1600.01
	8340.05		1600.02
<i>Audits of Colleges and Universities</i>	6960.01		1600.04
	6960.02		7100.01
	6960.03		7100.02
	6960.04	<i>Audits of Savings and Loan Associations</i>	6110.01
	6960.05	<i>Audits of State and Local Governmental Units</i>	6950.03
	6960.06		6950.05
	6960.07		6950.07
	6960.08		6950.08
	6960.09		6950.10
	7300.04		
	7300.10		
	7300.13		
<i>Audits of Construction Contractors</i>	1100.04	<i>Audits of Voluntary Health and Welfare Organizations</i>	6920.02
	2220.05		6920.03
	6700.01		6920.04
	6700.02		6920.06
	6700.03		6920.07
	6700.04		6920.08
	6700.09		6920.09
<i>Audits of Employee Health and Welfare Benefit Funds</i>	6930.02		7300.04
	6930.03		7300.09
	6930.04		7300.12
	6935.02	<i>Guide for Engagements of CPAs To Prepare Unaudited Financial Statements</i>	9420.06
<i>Audits of Finance Companies</i>	6130.02		9420.07
	6130.03		9420.14
	6130.04		9420.17
	6130.05		9420.21
	6130.06		9420.22
	6130.07		9420.23
	8340.01		9420.24

**Industry Audit Guides—(Cont'd)**

<b>Name of Guide</b>	<b>Sec.</b>	<b>Name of Guide</b>	<b>Sec.</b>
<i>Hospital Audit Guide</i>	2210.16	<i>Hospital Audit Guide</i>	6400.09
	6400.01		6400.10
	6400.02		6400.11
	6400.03	<i>Medicare Audit Guide</i>	6400.04
	6400.06		

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➡ The next page is 15,101. ←

**SECURITIES AND EXCHANGE COMMISSION****Securities and Exchange Act Releases**

No.	Sec.
9000	1100.01

**Accounting Series Releases**

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# 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.

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## ACC Section 10,000

## STATEMENTS OF POSITION

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

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**Section 10,010*****Statement of Position 74-6  
Recognition of Profit on  
Sales of Receivables  
with Recourse*****[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 14, 1974

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 AICPA Accounting Standards Division on Recognition of Profit on Sales of Receivables with Recourse. 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 takes the position that a uniform accounting approach is desirable for the recognition of profit or loss on sales of receivables with recourse and that the "delayed recognition" method rather than the "immediate recognition" method is preferable. This position is reached by examining the types of transactions in question, presenting the two prevalent methods of accounting for such transactions, describing the rationale supporting the use of each, and reviewing present accounting literature.

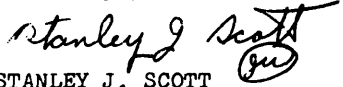
The Statement also examines the possibility that these transactions may be separated into the sale of receivables, on the one hand, and the retention of credit risks, on the other, profit and loss being allocated for each of these two elements of the overall transaction. A majority of the Executive Committee finds this method impracticable in most cases and without adequate theoretical basis. A minority finds that the technique is, under certain circumstances, not only practicable but preferable.

To: Mr. Marshall Armstrong - Page Two - June 14, 1974

Finally, the Statement sets forth recommended methods of systematic amortization for the "delayed recognition" approach and presents guidelines on disclosure for these transactions.

The Division would appreciate being advised as to the Board's proposed action on these recommendations.

Sincerely yours,

  
STANLEY J. SCOTT  
Chairman  
Accounting Standards Division

SJS/Lc

Enclosure

### 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.

## RECOGNITION OF PROFIT ON SALES OF RECEIVABLES WITH RECOURSE

### INTRODUCTION

.01 The Accounting Standards Division (the Division) of the American Institute of Certified Public Accountants has reviewed the accounting practices used by business enterprises for the recognition of profit (or loss) on sales of receivables with recourse.<sup>1</sup> The review indicated that in current practice two accounting methods are widely used in these transactions. The review also found that both accounting methods have been in use within specific industries. These two accounting methods are discussed in the "Current Practice" section of this Statement.

.02 In recent years accountants, regulatory authorities, investors, and other users of financial statements have expressed concern over the acceptability of alternative accounting methods in accounting for similar business transactions. The Division believes that it is not desirable to have alternative accounting methods acceptable for the recognition of profit on sales of receivables with recourse. Therefore, the Division is expressing in

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<sup>1</sup>The term *recourse* in the context of this Statement refers generally to the contractual right of a purchaser of receivables to demand payment from the seller of such receivables in the event of default by the debtor. However, the term may also refer to agreements between a buyer and a seller of receivables, such as guarantees by the seller of a "yield" to the buyer on the receivables sold, which constitute "recourse" in substance.

this Statement its position on a preferable method. Its position is set forth below under "The Division's Position."

.03 The scope of this Statement is restricted to the subject of profit (or loss) recognition on sales of receivables with recourse. This Statement does not discuss and is not intended to apply to the sale of receivables on a non-recourse basis, the recording of transactions giving rise to receivables, the imputation of interest on receivables<sup>2</sup> or the presentation of sales of receivables with recourse in financial statements.

.04 The Division's position as set forth herein applies to financial statements which purport to present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles. It also applies to regulated companies in accordance with the provision of the Addendum to APB Opinion No. 2, *Accounting for the Investment Credit* (1962).

### TERMINOLOGY

.05 The key terms in this Statement are defined below as they are used herein. Some additional definitions will be given as the need arises in the course of this Statement.

.06 *Receivables.* Receivables recorded under generally accepted accounting principles represent contractual rights to receive monies. They may arise from sales of products or services in the normal course of business which are due in customary trade terms (generally less than one year) and sales made pursuant to conditional sales contracts which are payable in monthly installments over periods often ranging from 3 to 10 or more years. Receivables may also arise from lending activities, such as mortgage loans for the purchase of real estate, direct cash loans to individuals, loans to businesses to finance working capital, and loans for other purposes. Certain contractual rights to receive monies, such as those related to unperformed portions of executory contracts, are ordinarily not recognized as receivables under generally accepted accounting principles.

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<sup>2</sup> Provisions for recognizing the appropriate rate of interest on receivables are discussed in APB Opinion No. 21, *Interest on Receivables and Payables*, and those provisions are applicable to the initial recording of transactions giving rise to receivables.



**.07 *Face Amount.*** The face amount is the sum of money outstanding on a legal instrument that obligates a party to pay another party a specified amount. It may be the exact amount expressed on a note, bond, conditional sales contract, etc. The face amount of a receivable may comprise some or all of the following:

- (a) The sales price of goods or services sold or the amount of a cash loan.
- (b) Finance charges (interest) to be collected and earned during the term of the receivable for the use of monies.
- (c) Service charges assessed the debtor for initiating the receivable, including such out-of-pocket costs as filing fees and credit investigation reports.
- (d) Fees for maintenance contracts purchased by the debtor and insurance premiums for various types of insurance coverage (generally credit life insurance, credit accident and health insurance, or fire and casualty insurance).

**.08 *Net Receivable.*** The net receivable is the *face amount* of the receivable less related unearned finance and service charges, unearned amounts applicable to executory contracts, and amounts included in the *face amount* for which the creditor's function is solely that of an agent such as insurance premiums to be collected and remitted to an insurance company. Sometimes the net receivable is equal to the *face amount*.

**.09 *Executory Contract Amount.*** The executory contract amount is the amount included in the *face amount* of a receivable representing the unperformed portion of an executory contract (such as a maintenance, management, or service agreement).

**.10 *Agency Amount.*** An agency amount is an amount in the *face amount* of a receivable representing the cost to the debtor of a service for which the seller or lender has acted only as an agent. Insurance premiums and maintenance fees may be agency amounts.

**.11 *Differential.*** The differential is the difference, after ad-

justment if necessary for executory contract and agency amounts, between the amount for which the receivable is sold and the *net receivable*. This difference is variously referred to as “endorsement fee,” “participation fee,” “placement fee,” “interest differential,” and “finance fee.” In those cases where the amount of the *net receivables* exceeds the amount for which the receivables are sold, the difference is usually termed “discount” or “loss.” In this Statement only the term “differential” will be used to describe the difference arising from the sale of receivables at either more or less than the *net receivables*.

## **BACKGROUND AND NATURE OF TRANSACTIONS**

.12 Some companies occasionally or regularly “package” some or all of their receivables and sell them to financial institutions or others to meet their financing needs. There is usually a difference between the *net receivables* and the amount for which the receivables are sold. In many instances the volume of receivables sold by companies is substantial, and the differential arising from such transactions is significant in the determination of results of operations of the seller. In addition to the volume of receivables sold, the differential may be dependent on such factors as the general level of interest rates, the stated interest rate of the receivables, the credit standing of the seller, the length of the payment period of the receivables, and the type and value of any security. Often receivables are sold on a recourse basis, and the seller of the receivables is obligated to reacquire the receivables in the event of a default by the debtor. The types of recourse arrangements will be examined after the calculation of the differential is explained.

.13 The examples below illustrate how differentials may be calculated. They are presented only as illustrations. Because there are many possible variations in agreements involving the sale of receivables, the determination of the differential will depend on the circumstances in each case. Although these illustrations assume the sale of whole receivables, there may also be sales of portions of receivables or groups of receivables in bulk without specific identification. In the cases below note that Example A includes the finance charges (add-on interest) in the face amount, whereas Example B does not. Example C illustrates

a contractual arrangement that includes finance charges and executory items in the face amount.

**EXAMPLE A :**

Sales price of goods.....	\$10,000
Less initial payment received.....	<u>1,000</u>
<i>Net receivable</i> (balance to be financed on an installment contract payable over 120 months).....	9,000
Add-on finance charges (14% per annum effective interest rate).....	<u>7,769</u>
<i>Face amount</i> of receivable (payable \$139.74 per month).....	<u><u>\$16,769</u></u>
Amount for which receivable is sold, i.e., face amount of receivable discounted to yield 10 $\frac{1}{4}$ % to the buyer (present value at 10 $\frac{1}{4}$ % of \$16,769 payable over 120 months).....	\$10,464
<i>Net receivable</i> .....	<u>9,000</u>
Differential .....	<u><u>\$ 1,464</u></u>

**EXAMPLE B :**

Original amount (principal) of a 6% note payable in equal monthly installments of \$119.90, including interest, over 360 months .....	\$20,000
Principal amount of 120 payments received to date of sale of receivable.....	<u>3,263</u>
<i>Face amount and net receivable</i> .....	<u><u>\$16,737</u></u>
Amount for which receivable is sold, i.e., net receivable discounted to yield 8% to the buyer (present value at 8% of 240 monthly payments of \$119.90)....	\$14,335
<i>Face amount and net receivable</i> .....	<u>16,737</u>
Differential .....	<u><u>\$(2,402)</u></u>

## EXAMPLE C:

Sales price of goods.....	\$ 5,000
Credit life insurance premium for a 3 year, single premium contract.....	\$ 150
Maintenance contract for 3 years.....	300
Total .....	<u>5,450</u>
Less initial payment received.....	<u>500</u>
Balance to be financed on an installment contract payable over 36 months.....	4,950
Finance charges at 12% per annum.....	<u>968</u>
Face amount of receivable (payable \$164.39 per month).....	<u><u>\$ 5,918</u></u>
Amount for which receivable is sold, i.e., face amount of receivable discounted to yield 10% to the buyer (present value at 10% of \$5,918 payable over 36 months).....	\$ 5,095
Net receivable (\$4,950 less \$300 maintenance contract fee and \$150 credit life insurance premium).....	<u>4,500</u>
Difference between the amount of proceeds and the net receivable.....	595
Less adjustment for executory item and insurance premiums (\$300 maintenance contract fee and \$150 credit life insurance premium).....	<u>450</u>
Differential .....	<u><u>\$ 145</u></u>

.14 When receivables are sold on a recourse basis, the form of recourse arrangements may vary. In some situations the buyer of the receivables is obligated to return any collateral security for the receivable to the seller before the seller is compelled to perform under the recourse arrangement. In other cases a mere default on payment by the debtor will obligate the seller to reacquire the receivable. In some instances the buyer of the receivables may remarket any goods it obtains by repossession and apply the proceeds therefrom against the receivable balance. In that event the seller may be required to pay any deficiency in the receivable balance remaining after the application of such proceeds. Sometimes the liability of the seller with respect to re-

course provisions is limited to stipulated amounts or percentages of the receivables sold. Such partial recourse arrangements may, however, provide the buyer adequate assurance of the recovery of his investment after considering the value of the collateral securing the receivable. In addition to reacquiring the receivable, the seller may also be required to refund to the buyer a portion of the differential originally received on the defaulted receivable, thus effectively guaranteeing the buyer a stipulated investment yield. Although the form of recourse arrangements may vary, in all cases the seller retains risks.

.15 The buyer's security in these transactions is frequently derived from a provision for the temporary retention by the buyer of a portion of the amount for which the receivables are sold. Such retained amounts are often referred to as "dealers' reserves" or "hold-backs." The terms governing "dealers' reserves" are defined in the agreement between the buyer and the seller of receivables. The amount of such "dealers' reserves" may be determined by the buyer based on loss experience developed from previous transactions with the seller or others. Amounts retained in "dealers' reserve" accounts are sometimes remitted to the seller as the reserve account exceeds stipulated percentages of the uncollected receivables. Agreements may provide that the "dealers' reserves" be charged for credit losses or rebates of finance charges resulting from either early extinguishment by the debtor or default. Some agreements may limit the buyer's recourse to the seller to amounts set aside in the "dealers' reserve." However, in most cases "dealers' reserves" represent a substantial security for the buyer's investment.

.16 The agreement between the buyer and the seller of receivables stipulates which party is to perform administrative and collection functions for the receivables sold. These functions are usually referred to as "servicing." If the seller retains the servicing functions, the agreement may provide for a "servicing fee" to be paid by the buyer. If the agreement does not specifically provide for compensation to the party performing the servicing, compensation for the future servicing will nevertheless be reflected in the amount for which the receivable is sold. Because the ultimate cost of the obligation to service is not determinable at the time of sale, the servicing provision necessarily enters into the degree of risk retained by the seller and accordingly influences the amount of the differential.

.17 Although, as previously mentioned, the unperformed portions of executory contracts are ordinarily not recognized as receivables under generally accepted accounting principles, they may be included in the face amount of the receivable. Ex-ecutory contract amounts usually enter into the risks retained by the seller. Normally these amounts are refundable to the buyer in the event of default, prepayment, or cancellation of a maintenance contract, etc., by the debtor. Therefore they influence the amount for which the receivable is sold and the differential and perhaps other terms of the agreement between the buyer and seller.

.18 There may be types of financing arrangements comparable in substance to transactions involving the sale of receivables. For example, a company may obtain from a lender a firm commitment<sup>3</sup> to provide financing to its customer prior to closing the sales transaction with the customer. In such cases at the time the sale is closed the customer receives the products or services sold, the lender obtains a receivable, and the company receives cash or other assets from the lender. In addition to receiving proceeds equivalent to the sales price of the product or services sold, the company may receive from the lender a portion of the finance charges stated in the receivable obtained by the lender. If the company guarantees the lender against loss arising from default by the debtor, the portion of the finance charges received from the lender is in substance the differential. To take another type of example, participation agreements or factoring arrangements, if they provide for recourse, may also be comparable in substance to transactions involving the sale of receivables and give rise to differential. In such cases the concepts discussed in this Statement regarding the recognition of profit arising from the sale of receivables with recourse are equally appropriate.

### CURRENT PRACTICE

.19 The following paragraphs discuss the two accounting methods commonly used by business enterprises for the recognition of profit on sales of receivables with recourse. For the purposes of this Statement, those two accounting methods are termed the "delayed recognition" method and the "immediate recognition" method. The delayed recognition method empha-

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<sup>3</sup> Financing commitments may be obtained directly from a lender or indirectly through intermediaries such as servicing companies.

sizes the financing aspects of the transaction. The immediate recognition method considers the sale of receivables with recourse a completed transaction giving rise to immediate profit or loss.

**.20** Sums obtained from the sale of receivables with recourse are sometimes treated as borrowings, with an accounting result for profit recognition similar to that in the delayed recognition method. When these transactions are treated as borrowings, the differential is not explicitly accounted for. In these cases the differential is in effect accounted for as two separate elements: an element representing interest income on the receivables and an element representing interest expense on the borrowing. The Division has not compared the borrowing treatment to the two accounting methods for recognizing profit on such sales because this Statement does not address the question of financial statement presentation for these transactions. However, much of what is said in this Statement about the delayed recognition method applies also to the borrowing treatment because of the similarity they share both in their accounting result for profit recognition and in their basic assumption, i.e., that the sale of receivables with recourse is primarily a financing transaction.

### **Delayed Recognition Method**

**.21** As stated above, the delayed recognition method emphasizes the financing aspects of the sale of receivables. The differential is recognized in the income statement in a systematic manner over a period of time usually corresponding to the term of the receivables sold. Usually no provision is recorded for refunds of differential in the event of default by the debtors or in the event of prepayment of the receivables. No separate provision for such refunds is required because the deferred differential contains an effective reserve for them. Similarly, the differential contains an effective reserve for any future administrative and collection functions to be performed by the seller. An allowance for uncollectible receivables, including estimates of expenses of and losses on reposessions, is customarily made in the accounting for receivables. This allowance remains in effect after the receivables are sold.

**.22** The rationale advanced for use of the delayed recognition method includes:

- (a) The sale of receivables with recourse is in substance a type of financing, in effect a borrowing by the seller.

When a selling price is negotiated, the negotiating process is analogous to that which occurs between a borrower and a lender. In determining an acceptable return for his investment, the buyer of receivables takes into account the seller's retention of certain risks and his ability to meet those risks, i.e., his credit standing. The buyer's return is then reflected in the dollar amount for which the receivables are purchased. If the receivables were never sold, the interest income on the receivables and the costs of "borrowed" funds used to finance the receivables would be recognized in results of operations over the term of the receivables. The differential represents interest income on the receivables, net of interest expense on funds effectively borrowed to finance the receivables. Therefore, the delayed recognition method accounts for the economic substance of the transaction.

- (b) "Realization"<sup>4</sup> occurs with the passage of time as the risks retained by the seller are diminished by payments made on the receivables, which reduce the amounts subject to refund in the event of default or prepayment. Thus, recognition of differential in income should coincide with the periods in which the risks that the differential may be refundable under the recourse provision diminish.
- (c) The method used for recognition of differential in income should be similar to that used by financial institutions in accounting for finance income because the differential essentially represents interest. The differential, taken together with the allowance for uncollectible accounts, represents the aggregate credits to which future losses should be charged.

**.23** In its review of current accounting practices, the Division found that the delayed recognition method is used predominantly by financial institutions (e.g., finance companies, banks, and savings and loan associations). However, this method is generally not used to recognize differential when the amount for which the receivables are sold is less than the *net receivables*. Even if the differential is a negative amount, the rationale for the delayed recognition method maintains that the analogy to financing trans-

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<sup>4</sup> See paragraphs .37-.39 for a discussion of the realization principle.



actions is valid. In such cases the buyer has negotiated a rate of interest from the seller that is higher than the rate that the seller had obtained from the debtor when the receivables were initially recorded. The buyer's higher rate discounts the receivables to a purchase price resulting in a negative differential. Negative differential is customarily termed "discount" or "loss." For those who account for sales of receivables with recourse as borrowings, the transactions involving negative differentials are simply characterized by a higher interest rate on the borrowed funds.

### **Immediate Recognition Method**

**.24** The immediate recognition method considers the sale of receivables with recourse a completed transaction giving rise to profit or loss at the time of sale. Under this method the profit or loss recognized is equivalent to the differential. A provision is made for refunds of differential in the event of default by the debtors or of prepayment of the receivables. If the seller is to perform future administrative and collection functions, a provision is made for their cost. An allowance for uncollectible receivables, including estimates of expenses of and losses on repossession, is customarily made in the accounting for receivables, and this allowance remains in effect after the receivables are sold.

**.25** The rationale advanced for use of the immediate recognition method includes:

- (a) The sale of receivables with recourse is a completed transaction. It is a three-party transaction, including a seller, a lender, and a debtor. The seller is in effect acting as a broker for the buyer of the receivables and is obtaining a commission to compensate him for his services (such as writing and packaging the receivables) up to the date the receivables are sold. If there is an analogy to financing in these transactions, it is due primarily to the relationship between the lender and the debtor. The lender must be concerned about the debtor's credit standing and ability to fulfill his obligations, whereas the seller's recourse obligations are only of secondary importance to him. The differential should therefore be recognized immediately because the earning process is complete.
- (b) The seller's recourse obligations are similar to a manufacturer's obligations under product warranties

or guarantees. In effect, the seller guarantees the quality of the receivables sold and should account for the consequences of such a guarantee in the same manner that a manufacturer accounts for its obligations under product warranties. Provisions are made in the period of sale for refund of the differential in the event of default by the debtor or in the event of prepayment of the receivables and also for future administrative and collection functions to be performed by the seller. In addition, an allowance for uncollectible receivables is made. Immediate recognition of differential is therefore appropriate.

**.26** In studying the use of the immediate recognition method the Division found that it is often employed by retailers and dealers in automobiles, mobile homes, furniture, jewelry, and home appliances and by certain companies whose primary business is servicing receivables originated by others. The Division also observed that if a seller has purchased credit insurance for protection against losses from default by the debtor, no provision is made for uncollectible accounts because the insurance company assumes those risks. In such cases, however, provision is usually made for refunds of differential resulting from default or prepayment by the debtor because such amounts are not covered by the insurance. Finally, when the immediate recognition method is used, negative differential is recognized immediately as loss. The immediate recognition of negative differential as loss is consistent with the rationale in support of this method.

**.27** The Division also found certain procedures which could be categorized either as a variation of the immediate recognition method or the delayed recognition method. For example, even if differential is being allocated over the term of the receivables, there are variations in the pattern of allocation. Another variation arises when differential is deferred to the extent that the buyer has retained a "dealers' reserve," and differential is recognized as profit only as amounts are released from the reserve. In this case the pattern of release may make the technique more or less similar to either method.

**.28** Although certain procedures may be categorized as variations of either method, the distinction between the two methods is nonetheless important because it defines the two ends of the spectrum of revenue recognition for sales of receivables with re-

course. The significant difference between the immediate recognition method and the delayed recognition method is in their respective timing of revenue recognition. The immediate recognition method isolates an amount that is recognized as profit at the date of sale. Under the delayed recognition method no profit is recognized at the date of the sale, rather all profit is recognized over the term of the receivables.

### **ADDITIONAL ACCOUNTING METHOD**

.29 In addition to the two accounting methods previously discussed in this Statement, the Division considered another method of accounting for profit or loss on sales of receivables with recourse. For the purpose of the following discussion, this additional accounting method is termed the “nonrecourse-market” method.

.30 The nonrecourse-market method is predicated upon the assumption that a sale of receivables with recourse has at least two distinctive aspects, the sale of the receivables and the retention of credit risks by the seller, and that profit or loss can be allocated to each aspect of the transaction. The first aspect of the transaction, the sale of receivables, is considered to be complete at the time of the exchange. The profit allocable to this aspect of the transaction is the amount of premium or discount that would have resulted from a sale of the same receivables on a non-recourse basis. The “premium or discount” is a component of the differential. It is the equivalent of the differential if the same sale had taken place without any recourse provision. Because the sale of the receivables is considered to be complete at the time of the exchange, the premium or discount is recognized in income in the period the receivables are sold.

.31 The second aspect of the transaction is the retention of credit risks arising from the recourse provisions. Assuming that no other aspects (such as servicing) are present in the transaction, the amount of differential allocable to the second aspect of the transaction is termed the “credit risk” component. This component of the differential is deferred at the time the receivables are sold and is recognized in income as the seller’s risks diminish over the period of time the receivables are to be outstanding. If either component can be measured, the value of the other may be obtained by subtraction.

.32 In some cases a transaction involving the sale of re-

receivables with recourse may involve more than just the two aspects discussed above. For example, the seller of the receivables may continue to service the receivables sold. If a servicing fee is not specifically provided for by the agreement between the seller and the buyer, a portion of the differential received by the seller would be deferred and recognized as income by the seller over the servicing period.

**.33** The theoretical basis of the nonrecourse-market method may be challenged on the ground that the isolation of a risk-free component of the differential does not accord with the contractual obligations of the seller. Under the nonrecourse-market method the credit risk component of the differential is separated at the time of the sale from the premium component, which is immediately recognized as profit. However, at that point the recourse provision applies to every dollar of differential. At any point during the term of the receivables the differential, no matter how accounted for, is refundable to the extent of a buyer's loss from default or prepayment by a debtor.

**.34** In any event, the effectiveness of the nonrecourse-market method is dependent on a reasonable assessment of the various components of the differential associated with each aspect of the transaction. The Division found that in certain cases data was available to compare the sale of receivables with and without recourse. In some cases, when the receivables are sold without recourse, the buyer insures them with an independent insurance company. If the nonrecourse-market method were to be applied to sales with recourse, the credit risk component of the differential could be measured by the insurance premium that would be paid to insure a buyer of receivables purchased without recourse against default by the debtor. In a limited number of cases information is available about the amount for which specific receivables can be sold on either a recourse or nonrecourse basis, with the difference in the two amounts being attributed to retention of the credit risks. In most cases, however, the Division believes that such measurements would not be objective because insurance rates are influenced by competitive forces within the insurance industry, because within a single industry the risk of default on receivables varies according to the proportion of the debtor's obligation that is met by his down payment, because the risk of default also varies according to the nature of collateral security provided by the seller, and because of other factors. Even when

there is a difference between the prices at which receivables are offered for sale with and without recourse, such difference may be attributable to the financial strength of the seller as well as to the characteristics of the receivables being offered for sale.

## **PRESENT ACCOUNTING LITERATURE**

.35 The Division found in existing pronouncements of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board no definitive guidance on accounting for profit or loss on sales of receivables with recourse. In fact, no specific pronouncement has been devoted exclusively to these transactions. However, the Division also examined recent pronouncements on applicable general principles to see if they provided clear guidance. The following paragraphs summarize the applicable general principles.

### **Revenue and Profit Recognition**

.36 The concepts of revenue realization are discussed in Accounting Principles Board Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (paragraphs 148 through 153). Realization is described as follows: "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" (paragraph 150). The term "earning" is described as "a technical term that refers to the activities that give rise to the revenue—purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth" (paragraph 149). APB Statement No. 4 holds that the realization principle requires that revenue be earned before it is recognized as income. Monies received or amounts billed in advance of the delivery of goods or performance of services are reported as unearned revenue until the earning process is complete.

.37 According to APB Statement No. 4, revenue may not be recognized without an exchange, and the timing of revenue recognition is generally determined by the time of the exchange. For example, revenue from the sale of a product is generally recognized upon delivery of the product to the customer; revenue from services is recognized when the services have been performed;

revenue from the sale of assets other than products is recognized at the date of the sale; and revenue from permitting others to use a business's resources (such as interest, rent, and royalties) is recognized as time passes or as the resources are used.

.38 In order for a sale to result in recognizable profit, the collection of the sale price must be assured. Accounting Research Bulletin No. 43 states, "Profit is deemed to be realized when a sale in the ordinary course of business is effected unless the circumstances are such that the collection of the sales price is not reasonably assured." This statement was reaffirmed in paragraph 12 of APB Opinion No. 10 in which the APB concluded that the installment method of recognizing revenue is not acceptable unless the circumstances are such that the collection of the sales price is not reasonably assured.

### The Current Trend

.39 The Division noted in recent pronouncements issued by the AICPA an increasing emphasis on deferring the point at which the earning process is considered to be complete and revenue and profit are recognized. This trend is evidenced by the accounting concepts set forth in the AICPA industry accounting guides *Accounting for Franchise Fee Revenue*, *Accounting for Profit Recognition on Sales of Real Estate*, *Accounting for Retail Land Sales*, and *Accounting for Motion Picture Films* and in FASB Statement No. 13, *Accounting for Leases*. According to these publications the completeness of the earning process may be determined based on such factors as (a) the transference from the seller to the buyer of the risks and rewards of ownership in the asset sold and (b) the seller's continuing involvement in the property sold (e. g., an obligation to perform services without reasonable compensation, guaranteeing a return to the buyer, or an obligation by the seller to repurchase the property sold). [As amended, effective January 1, 1977, by FASB Statement No. 13.]

.40 The Division also noted that accounting literature stresses that the economic substance of a transaction should determine the method of accounting (including the timing for revenue and profit recognition) if the economic substance of the transaction differs from its legal form. APB Statement No. 4 states, "Accountants emphasize the substance of events rather than their form so that the information provided better reflects the economic activities represented."

## THE DIVISION'S POSITION

**.41** The Division finds persuasive the rationale advanced for use of the delayed recognition method. Sales of receivables with recourse have significant characteristics of financing transactions in which monies are borrowed and assets are pledged as security thereon. This conclusion is based on the fact that the seller's risks have not been diminished by the sale transaction and on the fact that the differential has the attributes of finance income. The seller's risks are retained by the recourse provision, which also effectively pledges his assets as security for the sum advanced by the buyer. The differential represents primarily the difference between the value of the interest on the receivables sold and the value of the interest on the funds advanced by the buyer. The interest rate at which the buyer is willing to advance funds to the seller reflects the fact that risks are retained by the seller and also reflects his credit standing. These considerations are implicit in a lending transaction. The Division therefore concludes that the use of the delayed recognition method is preferable to the use of the immediate recognition method.

**.42** For reasons outlined earlier in this Statement the Division questions the theoretical basis of the nonrecourse-market method and believes that practical problems usually prevent reasonable measurement of the components of the differential. It therefore believes the method should not be accepted. A minority of three members of the Accounting Standards Executive Committee dissents from this position. They believe that there are situations where the credit risk component is clearly measurable and in those instances the nonrecourse-market method is practicable and preferable.

### Application of the Delayed Recognition Method

**.43** The variations that the Division noted in the patterns of recognizing deferred differential suggest that divergent accounting treatments are in use. The Division therefore offers in this section its views on how the delayed recognition method should be applied.

**.44** Use of the delayed recognition method calls for the amortization to operations of the differential as the risks of the seller diminish, thereby recognizing income as the earning process is completed. In order to recognize the diminishing risks of the seller the differential must be divided into its two essential

elements, interest income and interest expense.<sup>5</sup> The differential can then be amortized by obtaining the net result of the accounting for the two essential elements. Although this division is necessary in order to account for income as risks diminish, in the financial statements the differential should be presented as a net amount.

**.45** The Division believes the element equivalent to interest expense should be accounted for as is customary in accounting for the cost of borrowed funds, that is, by application of a constant rate of interest to the amount outstanding at the beginning of a given period. The amortization to operations of the element equivalent to interest income should recognize the costs and diminishing risks of the seller. This may be achieved by any of four procedures. The choice of the most appropriate procedure should be governed by the circumstances. The interest income element may be accounted for by application of a constant rate of interest to the amount of receivables outstanding at the beginning of a given period. It may also be accounted for, depending upon the circumstances, by using one of the three methods provided by the AICPA Industry Audit Guide *Audits of Finance Companies*. According to this Guide, interest income, referred to as "deferred finance income," may be accounted for by the combination method, the effective yield method without transfer, and the pro rata method with transfer. The Guide also presents criteria for the use of other methods that may be more practical in certain circumstances.

**.46** The Division recognizes that at times the buyer's recourse to the seller for defaults by the debtor or refunds of differential may be limited to specific maximum amounts (e.g., the amount in a "dealers' reserve") which will cause practical problems in application of the delayed recognition method in the manner described in the preceding paragraph. If it is not practicable to

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<sup>5</sup> Allowances for uncollectible receivables are not part of the differential and should be accounted for separately. They are customarily made in the accounting for the unsold receivables and remain in effect after the receivables are sold, unless the risks of default by the debtor are assumed by others (e.g., a credit insurer). After the receivables are sold, allowances for uncollectible receivables should be adjusted as necessary.

Differences arising between the financial accounting for periodic recognition of profit or loss on sales of receivables and the income tax accounting for such profit or loss should be treated as timing differences in accordance with APB Opinion No. 11, *Accounting for Income Taxes*.



divide the differential into interest income and interest expense elements, the differential may be amortized by approximating the collections of the receivables and taking differential into income as the risks are thereby diminished. The goal of amortizing the differential to operations as the seller's risks diminish may be approximated by the sum-of-digits method when the receivables are payable in regular, equal installments.

.47 Direct costs incurred during the sale of receivables with recourse may be deferred and amortized to operations on a basis that will match such costs with the amortization of the differential. Costs directly incurred during the consummation of these sales (such as legal fees and costs of preparing and processing documents for transferring ownership of the receivables to the buyer) are similar to costs that might be incurred in the issuance of debt. These costs must be distinguished from the direct or indirect costs incurred in order to derive revenue from the sale of goods or service.

### Disclosure

.48 The Division believes that disclosures for the sale of receivables with recourse should follow the requirements of FASB Statement No. 5, *Accounting for Contingencies*. In general, disclosure should include the nature and amount of the receivables sold during each period in which an income statement is presented, specifying the payment terms, and the amount of any receivables still outstanding at the date of the latest balance sheet presented. In addition, the financial statements should disclose the terms of the agreements, describing the conditions that would compel the seller to perform under the recourse provisions and any provisions for "dealers' reserves." The amount of funds in the "dealers' reserves" at the date of the latest balance sheet presented should also be given. [As amended, effective July 1, 1975, by FASB Statement No. 5.]

.49 The Division believes that a company's accounting policy for profit or loss on the sale of receivables with recourse should be disclosed in accordance with the provisions of APB Opinion No. 22, *Disclosure of Accounting Policies*. The amount of differential included in each period for which an income statement is presented and the amount deferred at the date of the latest balance sheet presented should also be disclosed.

## ACCOUNTING STANDARDS EXECUTIVE COMMITTEE

June 14, 1974

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## 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

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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.

## 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.

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**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-

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\* 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.<sup>1</sup>

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

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<sup>1</sup> 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
<b>Unrestricted</b>		
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
<b>Total unrestricted .....</b>	<b>1,006,000</b>	<b>745,000</b>
<b>Restricted</b>		
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	—
<b>Total restricted .....</b>	<b>460,000</b>	<b>426,000</b>
<b>Total current funds.....</b>	<b>1,466,000</b>	<b>1,171,000</b>

## 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	—
<b>Total loan funds.....</b>	<b>683,000</b>	<b>502,000</b>

## Endowment and Similar Funds

Cash .....	100,000	101,000
Investments .....	13,900,000	11,800,000
<b>Total endowment and similar funds....</b>	<b>14,000,000</b>	<b>11,901,000</b>

## Exhibit 1

## Sheet

19\_\_\_\_

at June 30, 19\_\_\_\_

## Liabilities and Fund Balances

## Current Funds

	Current Year	Prior Year
<b>Unrestricted</b>		
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 .....	643,000	455,000
Total unrestricted .....	<u>1,006,000</u>	<u>745,000</u>
<b>Restricted</b>		
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><u>1,466,000</u></u>	<u><u>1,171,000</u></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><u>683,000</u></u>	<u><u>502,000</u></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 .....	1,360,000	941,000
Total endowment and similar funds....	<u><u>14,000,000</u></u>	<u><u>11,901,000</u></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.....	<u>250,000</u>	<u>253,000</u>
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 .....	<u>100,000</u>	<u>80,000</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**

Cash .....	50,000	70,000
Investments .....	<u>60,000</u>	<u>20,000</u>
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 .....	<u>235,000</u>	<u>200,000</u>
Total renewals and replacements..	<u>260,000</u>	<u>380,000</u>
Retirement of indebtedness		
Fund balances		
Restricted .....	185,000	125,000
Unrestricted .....	<u>115,000</u>	<u>168,000</u>
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.....	<u>110,000</u>	<u>90,000</u>
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,

	Current Funds	
	Unrestricted	Restricted
<b>Revenues and other additions</b>		
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>
<b>Expenditures and other deductions</b>		
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**

<b>Transfers among funds—additions/(deductions)</b>	<b>Current Funds</b>	
	<b><u>Unrestricted</u></b>	<b><u>Restricted</u></b>
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 .....	<u>(1,122,000)</u>	
Net increase/(decrease) for the year.....	188,000	25,000
Fund balance at beginning of year.....	<u>455,000</u>	<u>421,000</u>
Fund balance at end of year.....	<u><u>643,000</u></u>	<u><u>446,000</u></u>

*See accompanying Summary of Significant Accounting*



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
					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)
40,000		40,000	
<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</u> <u>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.

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\* 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.

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➡ *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.

➡➡ The next page is 17,153. ⬅➡



### 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."<sup>1</sup>

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<sup>1</sup> 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’.”<sup>2</sup>

.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.”<sup>3</sup>

.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.”

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<sup>2</sup> *Ibid.*

<sup>3</sup> *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.

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➡ *The next page is 17,451* ←



**Section 10,040*****Statement of Position 74-12  
Accounting Practices in  
the Mortgage Banking  
Industry*****[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

December 30, 1974

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 in the Mortgage Banking Industry. 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 takes the position that a mortgage banker's loan portfolio (other than loans held for long-term investment) should be valued using the lower of cost or market method. A mortgage banker will occasionally hold mortgage loans for long-term investment, and in those situations the cost method of valuing such loans is found to be appropriate. The Statement recommends procedures to be followed in determining the lower of cost or market in various circumstances and offers guidance for identifying those mortgage loans which are long-term investments.

With respect to transactions between affiliates, the Statement notes that, except in rare circumstances, generally accepted accounting principles require the postponement of profit until sale to unrelated third parties. Consequently, it takes the position that sales of mortgages to an affiliate by a mortgage banker should, in most cases, be recorded at the lower of cost or market value at the date a management decision has been reached that a sale between affiliates will occur.

The Statement indicates that both classified and unclassified balance sheets are acceptable, but recommends that mortgages held for sale and mortgages held for investment should be distinguished in any balance sheet.

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 (encl)*

STANLEY J. SCOTT  
Chairman  
Accounting Standards Division



### 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 IN THE MORTGAGE BANKING INDUSTRY

### INTRODUCTION

.01 The Accounting Standards Division of the American Institute of Certified Public Accountants has reviewed certain accounting practices used by mortgage bankers in accounting for their inventory of permanent mortgage loans held for sale and in preparing their balance sheets. This review indicated that two accounting methods are widely used in accounting for such loans held for sale, the cost method and the lower of cost or market method. The review also indicated that practices vary in measuring the lower of cost or market and in recording transactions with affiliates. Both classified and nonclassified balance sheets were also noted.

.02 In recent years, accountants, investors and other users of financial statements have expressed concern over the acceptability of alternative accounting methods in accounting for similar business transactions. The Division believes that it is not desirable to have alternative methods and measurement practices acceptable for accounting for mortgage loans held for sale by mortgage bankers. Therefore, the Division is expressing in this Statement its position on a preferable accounting method and on preferable measurement practices for such mortgage loans.

.03 The Division's position as set forth herein applies to fi-

financial statements of mortgage bankers which purport to present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles.

.04 The key terms in this Statement are defined in the Glossary. Excerpts from accounting literature relating to each Division position are also included in an Appendix.

### **THE MORTGAGE BANKING INDUSTRY**

.05 Mortgage bankers, an important part of the real estate industry, by bringing potential borrowers and investors together, originate, market and service real estate mortgage loans. Other mortgage banking operations, including insurance, property management, real estate development and sales, management of real estate investment trusts and joint venture investments are subsidiary or collateral to the fulfillment of this primary role. While some mortgage bankers trace their ancestry to real estate firms operating prior to 1900, the real impetus to mortgage banking occurred in the 1930s with the advent of the insurance of residential mortgages by the Federal Housing Administration. The existence of government insurance enhanced the salability of such loans to financial institutions, particularly in capital-rich areas. Both by law and custom, the geographically distant permanent investor needed a local representative to collect payments, make periodic property inspections, and make certain that insurance and property tax payments were kept current by mortgagors. After World War II, residential loans guaranteed by the Veterans Administration became an important source of loan origination and servicing operations for mortgage bankers. In recent years, mortgage bankers have also originated a significant volume of non-insured residential loans and of income property mortgages, including loans on shopping centers, office buildings and multi-family apartment complexes. A considerable number of these income property or commercial loans are originated for sale on a servicing-released basis, with the servicing performed by the investor. However, most servicing of residential loans and a very significant portion of the servicing of commercial loans is still performed by the mortgage banker for a fee based on a percent of the outstanding principal balance of the loan.

.06 Mortgage bankers acquire mortgage loans for sale to permanent investors from a variety of sources. Among these

sources are applications directly from borrowers, purchases from realtors and brokers, purchases from investors and conversions of various forms of interim financing, such as construction loans, to permanent financing. Residential loans guaranteed or insured by the Federal Housing Administration or the Veterans Administration have usually been acquired at a discount from par, due to the submarket interest rate of such loans. Non-Federally guaranteed or conventional residential mortgages are also often acquired at a discount from par. Commercial loans are generally acquired at par. Current industry practice, with which the Division agrees, is to defer recording any purchase discounts as income until final placement of the loans with the permanent investor.

.07 The mortgage banker sells the mortgages he originates to a variety of permanent investors, including savings and loan associations, mutual savings banks, insurance companies, pension funds, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. Since 1970, many mortgages have also been placed in trusts to collateralize Mortgage Backed Securities issued by mortgage bankers and guaranteed by the Government National Mortgage Association. Mortgage banker activities thus primarily consist of two separate but interrelated operations: the origination and marketing of real estate mortgages, and the subsequent long-term servicing of such loans.

.08 Most mortgage bankers originate and service two types of loans, residential and income or commercial. While the servicing procedures are somewhat similar for the two loan types, the origination operations are significantly different and almost always require separate organizations, procedures, and decisions. Residential loans are usually obtained directly from borrowers referred to the mortgage banker by real estate brokers or builders. Since the amount of any one loan is relatively small, the mortgage banker will often originate residential loans without specific commitments from a permanent investor to purchase the loans. If the mortgage banker has any commitment to cover such loans it will normally be a block commitment for a large dollar volume of residential loans meeting broad general criteria.

.09 Income or commercial loan origination procedures differ significantly from residential loan originations. Some of the more common commercial loan origination procedures are:

- (a) Normally, the mortgage banker does not issue a commitment to the borrower without first obtaining an investor's commitment to purchase the specific loan.
- (b) Each borrower's loan application is matched to an investor's commitment rather than packaging several loans to one commitment.
- (c) A single commercial loan representative may deal with both the borrower and the investor.
- (d) Each loan is usually large in amount and requires careful appraisal, analysis, and packaging for an investor commitment.
- (e) Most loans, upon borrower acceptance of the permanent loan commitment, are not funded for several months until construction of the project is completed.

.10 After originating a mortgage loan the mortgage banker normally must hold the loan for a period ranging from 60 to 180 days, during which time processing of documentation is completed and marketing efforts are made. During the processing period the loans are usually pledged as collateral for the short-term bank loans (the "warehouse line") used to finance the purchase and ownership of the mortgages. During the holding period the mortgage banker must assume the primary risk for the collectibility of the loan, fluctuations in carrying costs due to changes in short-term interest rates, and fluctuations in the final sales price of the loan due to changes in long-term interest rates. These risks may be partly reduced through government guarantees or through the purchase from permanent investors of commitments to buy loans at stated prices and under stated conditions, as described in paragraphs .08 and .09.

## **BASIS OF VALUATION OF MORTGAGE LOANS OWNED**

### **Current Industry Practice**

.11 Mortgage bankers have traditionally been short-term brokers of mortgage loans, acquiring such loans from third parties, processing and marketing them, and selling them to permanent investors. The mortgage banker has typically not become an investor himself because of a desire to avoid competing with his investors and because mortgage bankers generally have had limited equity and long-term funds. However, mortgage loans

held for sale, because of the 60 to 180 day processing period, usually constitute the largest asset owned by a mortgage banker.

.12 Practices with regard to risks assumed by mortgage bankers during the processing and marketing phase of their operating cycle have varied. Some mortgage bankers have avoided assuming any risk by purchasing commitments from investors to cover loans as they are acquired, and thus only in rare circumstances could these mortgage bankers suffer a marketing loss. Other companies have elected to rely on their marketing efforts to avoid a loss on the sale of their loans, and even hopefully to generate a profit, and consequently have not acquired commitments for any of their loans. Most companies, of course, fall between these two extremes, obtaining specific commitments for commercial loans and block commitments for some of their residential loans. Such block commitments, when purchased in advance of loan production, carry some element of risk because changes in acquisition costs may reduce or eliminate the protection afforded by such commitments. Finally, although rare, an investor may fail to honor a commitment, so that the mortgage banker assumes some risk even with fully committed loans.

.13 The following paragraphs discuss the two valuation methods, "cost" and "lower of cost or market", commonly used by mortgage bankers during the processing and holding period to account for their mortgages owned. These loans, variously labeled "inventory", "loans held for sale to others", "mortgage loans" or "mortgage loans receivable", are classified as current assets by mortgage bankers using classified balance sheets. A majority of mortgage bankers, in terms of asset size and servicing portfolio size, use the lower of cost or market valuation method. A minority of mortgage bankers use the cost valuation method.

#### **Cost Valuation Method**

.14 The cost valuation method defers any adjustment for changes in the market value of mortgage loans until completion of the processing and marketing period. Acquired loans are recorded at the principal balance of the loan with any acquisition discounts placed in a purchase discounts account and offset against the related asset on the balance sheet. While industry practice is to record origination fees as income at loan closing,

some companies defer recognizing such fees until the loans are sold to investors.

#### **Lower of Cost or Market Valuation Method**

.15 The lower of cost or market valuation method recognizes, during the holding period, any decrease in estimated net realizable value below acquisition cost. Specific industry practices with respect to the computation of the lower of cost or market are discussed in detail in paragraphs .22 through .24.

### **THE DIVISION'S POSITION**

#### **Loans Held for Sale**

.16 All, or almost all, of the loans owned by a mortgage banker are held for sale during his normal business cycle either as individual loans or as collateral for GNMA securities. Occasionally, some owned loans may be held for longer periods as described in paragraphs .17 through .21. The basic accounting concepts relating to the use of the cost or lower of cost or market methods for valuing loans held for sale are discussed in detail in the accounting literature quoted in paragraphs .44 through .51. The Division finds convincing the rationale advanced for the use of the lower of cost or market valuation method for loans held for sale by mortgage bankers. This conclusion is based on the fact that such a valuation method most clearly represents the economic realities of the mortgage banker's operations. The Division believes that mortgage loans held for sale have characteristics similar to both accounts receivable and finished goods inventory, even though some processing and marketing efforts may still have to be made. Consequently, the accounting principles recommended by the Division are drawn from the principles followed in providing for valuation adjustments for receivables and for reduction of carrying values to the lower of cost or market for inventories. The Division further believes that the computation of market value requires some variation from procedures followed in valuing manufacturing inventories. Such variations are discussed more fully in paragraphs .25 through .32. The Division believes the cost method for valuing loans held for sale fails to reflect economic realities and fails to meet the "conservatism", "accrual", or "measuring of unfavorable event" principles of accounting and, therefore, should not be acceptable.

### **Loans Held for Market Recovery**

.17 The mortgage banker may hold mortgage loans or GNMA securities for extended periods of time if he expects a favorable long-term interest trend. Although these loans may technically not be held for sale during the company's normal operating cycle, the Division believes such loans should also be valued in accordance with the lower of cost or market method prescribed for loans held for sale.

### **Loans Held for Long-term Investment**

.18 The Division finds that accounting practices followed for many years by commercial banks, savings and loan associations, insurance companies and others support the use of the cost method of valuing mortgage loans held as long-term investments. While historically mortgage bankers have not customarily made long-term investments in mortgage loans, the Division recognizes that occasionally such companies may choose to make such investments. The Division considered two areas of concern associated with a mortgage banker's making long-term mortgage loan investments: (1) ways to distinguish between long and short-term investments and (2) the definition of cost.

.19 Determination and verification of a mortgage banker's intent to carry mortgage loans as a long-term investment will always be a difficult judgment. The Division believes that the following conditions, as they existed at the time the investment decision was made, should be considered in verifying a mortgage banker's intent to carry mortgage loans as a long-term investment:

- (a) The loans are to be segregated in the accounting records and reports of the company.
- (b) There is documentary evidence of a corporate decision to hold such loans to maturity or at least for an extended term.
- (c) The loans will be classified as non-current assets if the company's balance sheet is classified.
- (d) The mortgage banker has the financial strength to carry such investments for extended periods. Evidence of such financial strength would be an amount of equity and long-term borrowings in excess of the carrying value of such investments. A non-revocable

line of credit, effective for the projected holding period from a substantial financial institution would also constitute evidence of substantial financial strength.

.20 The Division believes mortgages transferred into a long-term investment category must be transferred at the lower of cost or market, as defined in paragraphs .25 through .32, at the date of transfer, except that the carrying value of such loans must be further reduced, if necessary, to provide a yield not less than the rate of interest paid on the debt, if any, used to carry the investment. While the transfer to long-term investment will terminate any necessity to write down such loans further in the event of subsequent market declines, the Division also believes it is inappropriate to adjust such loans for any subsequent market recovery. Consequently, so long as a mortgage banker holds loans as long-term investments, such loans should be valued at the lower of cost or market at the date of formal identification as a long-term investment, unless some event occurs indicating a permanent impairment of value, in which case a further reduction in carrying value may be necessary. The Division does believe that, with respect to long-term mortgage loans, any difference between par value of the loans and carrying value as determined above should be amortized and recorded in income. Since mortgage loans are rarely outstanding for their full term, due to prepayments, sales of property etc., the Division believes this amortization may be based on the estimated life of the loans instead of their stated term.

### **Loans Sold Under Repurchase Agreements**

.21 Some mortgage bankers, as a means of financing a portion of their inventory of loans held for sale, temporarily transfer such loans to banks or other financial institutions under repurchase agreements. When the loans are marketed to permanent investors they are reacquired from the banks and sold to the investors. The loans may also be temporarily transferred without a formal repurchase agreement but under circumstances which indicate such an agreement exists on an informal basis; e.g., all marketing efforts are made by the mortgage banker, not the bank; the positive or negative interest spread is the property of the mortgage banker; fluctuations in loan market values are the risk of the mortgage banker; uncollectible loans are reacquired



by the mortgage banker; and the mortgage banker routinely reacquires all or almost all of the loans from the bank and resells them to permanent investors. While loans transferred to banks under such "sold loan lines" may technically be sales, the Division believes the existence of a formal repurchase agreement or the existence of evidence of an informal repurchase practice indicates that the risk of market loss is retained by the mortgage banker and such transactions are essentially financing in nature and should be accounted for as such. Therefore, the Division believes the mortgage banker should value all such loans at the lower of cost or market whenever making a loan valuation computation. GNMA certificates sold under repurchase agreements should also be valued at the lower of cost or market.

## **DEFINITION OF LOWER OF COST OR MARKET**

### **Current Industry Practice**

.22 Mortgage bankers generally have two types of loans held for sale: (1) those loans that have been originated specifically to fill existing investor commitments and (2) those loans originated on a speculative or uncommitted basis to fill future investor needs. Mortgages, like other assets, are initially recorded at cost. Cost is generally considered to be the cash or fair value of other assets given in exchange for the asset acquired. While outlays incident to the acquisition as well as the outlay for the asset itself are generally considered to comprise the cost of the asset, the mortgage banking industry generally has not attempted to capitalize the administrative costs involved in the origination of a mortgage. This is due to many factors, including the charging of an origination fee, usually 1% of the mortgage amount, to cover some or all of these origination costs.

.23 Most mortgage bankers have reduced the carrying value of their loans held for sale to market when such market value was less than cost. Generally, such valuation computations are made in the aggregate, either in total or by type of loan, so that any potential losses are reduced by potential gains before a write-down is recorded. However, some companies calculate the write-down on an individual loan basis without offsetting gains against losses. The market values used for comparison are usually those associated with each company's normal investor outlets.

.24 Loans held for sale by mortgage bankers are almost universally financed with short-term bank borrowings collateralized

by the mortgages. Normally, long-term mortgage interest rates exceed the short-term rates mortgage bankers pay the banks and a favorable interest spread is an important source of income to the mortgage banker. On occasion, sometimes for extended periods, such short-term rates are higher than long-term rates. This condition not only puts powerful economic pressure on the mortgage banker but also creates an additional problem of valuation. Very few mortgage bankers have considered this "negative interest" factor in their valuation procedures, although some have considered it in their marketing strategy, but if loans are to be held for extended periods, because of market or other conditions, such a factor could become a material problem.

### **The Division's Position**

**.25** The Division concludes that the procedures described in paragraphs .26 through .30 should be used in defining the lower of cost or market basis for mortgage loans held for sale.

### **Computation of Market**

**.26** Market value of mortgage loans and GNMA Mortgage Backed Securities should be computed by appropriate type of loan with, at a minimum, separate computations made for residential and commercial loans. When calculating the lower of cost or market, either the aggregate or individual loan basis may be used, and the method used should be disclosed in the financial statements. The computation of market is a two tier calculation as follows: first, those loans held subject to existing purchase commitments (committed loans) and, second, those loans held on a speculative basis (uncommitted loans).

*Committed Loans and GNMA Securities:* Market value for loans and GNMA securities covered by investor commitments should be computed based upon commitment prices. These loans must meet the specific terms of the commitments. Where such loans do not meet the requirements of the commitments, or there exists a reasonable doubt as to acceptance, the loans should be considered uncommitted loans for the calculation of market value.

*Uncommitted Loans:* Computations of market value for uncommitted loans should be based on the market within which the mortgage banker normally operates. This would include consideration of the following:

- (a) Commitments obtained after or shortly before balance sheet date. To the extent such commitments clearly represent market conditions existing at year end, market value computations should be based on these commitment prices.
- (b) General indications of market prices and yields sought by the company's normal market outlets.
- (c) Quoted GNMA security prices or other public market quotations for long-term mortgage loan rates.
- (d) Federal National Mortgage Association Free Market System action prices. Generally all mortgage banking firms are approved seller/servicers of the Federal National Mortgage Association (FNMA) which is the major secondary market source of funds for mortgage bankers. FNMA operates a nationwide mortgage action program called the Free Market System which gives an indication of current market prices for both government and conventional loans via an action system for the purchase of FNMA's commitment to acquire loans from seller/servicers at specific periods of time.

*Uncommitted GNMA Mortgage Backed Securities:* The mortgage banker may hold GNMA securities in the open market for trading purposes. With respect to the uncommitted securities which are collateralized by his own loans, the current market value of the underlying loans and the current market value of the securities will normally be very similar. If the trust holding the mortgage banker's own loans may be readily terminated and the loans sold directly, the securities may be valued at the lower of cost or market of either the loans or the securities, preferably based on the mortgage banker's sales intent. Other GNMA securities should be valued at the lower of cost or market using the published GNMA securities yield.

*Costs Associated with Bulk Purchases:* Mortgage bankers sometimes acquire large blocks of existing mortgage loans from investors, including GNMA. Some mortgage bankers have capitalized certain costs associated with these purchases as costs of future servicing income and amortized such costs over the estimated life of the loans. Where such

capitalization is appropriate, the costs to be capitalized may be excluded from the cost of the mortgages for the purpose of establishing the lower of cost or market. Where such capitalization is not appropriate, such costs must be considered as part of the cost of the mortgages.

#### **Valuation Dates and Subsequent Changes in Market Conditions**

**.27** Valuations are to be made at the close of all stockholder reporting periods, including those for interim financial statements. The provisions of APB Opinion No. 28 as to temporary market declines may be applied to such interim financial statements if market conditions have actually improved subsequent to the interim reporting period. Otherwise, market changes subsequent to the valuation date should be considered subsequent period events and, if such changes are material, adequate disclosure should be included in the notes to financial statements as set forth in Sections 560.05 and 560.07 of Statement on Auditing Standards No. 1.

#### **Subsequent Recoveries of Previous Writedowns**

**.28** The Division believes, as previously noted, that the lower of cost or market valuation procedure for mortgage bankers combines elements of receivable valuation with elements of inventory valuation. Traditionally, inventory valuation concepts have required that, with respect to items which have been written down below cost, the reduced amount is to be considered "cost" for subsequent accounting purposes. Conversely, receivable valuation reserves have often been determined for each reporting period independently, so that receivables are carried at current realizable value. The Division believes it is acceptable for a mortgage banker to calculate the lower of cost or market value at each valuation date independent of any previous calculation. Thus, loans written down in one accounting period (other than those held for long-term investment—see paragraph .20) need not be carried at such reduced value in a later period if their market value has partly or completely recovered.

#### **Excess of Interest Paid Over Interest Received During the Period Mortgages Are Held Pending Sale to Investors**

**.29** Occasionally, interest paid on warehouse lines exceeds interest received on the underlying mortgage loans. This phe-

nomenon of short-term interest rates exceeding long-term rates is unusual and has occurred infrequently in the past. The Division views the warehousing of mortgages as essentially a financing activity and, accordingly, any negative spread should be charged to current operations as incurred.

### **Servicing Fee Rates at Other Than Current Market**

.30 Occasionally, a mortgage banker will sell or commit to sell loans at a servicing fee rate that is significantly different from rates currently prevalent in the industry. In such cases the loans will generally be sold at prices higher than otherwise available. The result is the recognition of increased income (or reduced loss) at the time of sale offset by reduced servicing income to be recognized in future periods. In other cases a mortgage banker may act as a broker and sell loans with servicing released (no servicing income to be collected nor is the mortgage banker to perform any servicing functions) to either the investor or another servicer. This circumstance is particularly apt to occur with respect to commercial loans, and the mortgage banker may or may not have known and considered the terms of sale at the time the related loans were produced and their acquisition cost was negotiated. In some such cases the loans may be sold at prices higher than otherwise available, in which instance the result would be the recognition of increased income (or reduced loss) at the time of sale but with no servicing income nor related servicing cost in future periods.

.31 The Division concludes that when loans are sold with servicing released, no adjustment of the sales price should be made. However, when loans are sold at a servicing fee rate that is significantly lower than rates currently prevalent in the industry, the Division concludes that an adjustment to the sales price will be required whenever the impact on operating results is significant. Such adjustments would result in deferred credits to be written off into servicing fee income over future years. The amount of any such adjustment and the method of write-off should be determined in such a way that the resulting total of the write-off and actual servicing fee income recognized in each subsequent year from the related loans would approximate the servicing fee income that would have been earned in each subsequent year if the related loans had been sold at a "normal" servicing fee rate. Any such adjustment should be made as of the

date the sale of the loans is recorded and any resulting gain or loss is recognized. An adjustment may similarly be required if servicing rates are significantly higher than normal. In determining the market value of mortgage loans held for sale, a similar adjustment should be made to the sales price of any commitment which provides for a servicing fee rate that is lower than rates currently prevalent in the industry.

**.32** The Division recognizes that it may be difficult to determine what are "normal" servicing fee rates currently prevalent in the industry. It is necessary that such a determination be made both for the purpose of deciding whether an adjustment is required and for the purpose of quantifying the amount of the adjustment. The Division concludes that a minimum acceptable "normal" servicing fee rate is one that will provide, over the estimated life of the loans, servicing fee income in excess of estimated servicing costs.

## **ACCOUNTING FOR TRANSACTIONS WITH AFFILIATES**

### **Current Industry Practice**

**.33** Mortgage banking firms began generally as relatively small, independently owned businesses with nominal equity. They financed their operations, particularly loans held for sale, through bank borrowings collateralized by the related loans. Many mortgage banking firms subsequently were acquired by larger financial institutions. This change was heightened with the expansion of bank holding companies and the inclusion of mortgage banking as a permitted activity by the Board of Governors of the Federal Reserve System. The acquisition of mortgage banking firms resulted in the acquired firms having access to much greater amounts of capital for carrying their mortgage loan inventories and for expansion in construction and development lending.

**.34** As many mortgage bankers have become affiliated with banks and other financial institutions the number and magnitude of transactions with related companies have increased. Generally, mortgage loan transactions between affiliated companies have been recorded at the lower of cost or market at the date of transfer. However, some of these transactions have been recorded at original cost, thus not recognizing any marketing losses, since the mortgage banker recovers his basis in the loans and the purchasing affiliate records the loans in its investment account at

cost. Occasionally other affiliate transaction techniques have been used, such as purchases at cost using non-interest bearing notes or purchases on a zero-servicing-fee basis. Some mortgage bankers have reported gains or losses on sales of mortgages to their affiliates in the mortgage banker's separate financial statements but have eliminated such gains or losses in the group's consolidated financial statements, while others have reflected such gains and losses on both separate and consolidated financial statements. Transactions with affiliates are a particular problem for mortgage bankers because they must issue separate financial statements.

### **The Division's Position**

**.35** APB Opinion No. 18 establishes a number of criteria for determining whether a subsidiary or affiliate relationship exists. These criteria include (a) a presumption of an affiliated relationship if a 20% or greater voting stock ownership exists, either directly or indirectly, and (b) the ability to exercise significant influence over operating and financial policies. The ability to exercise significant influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. The Opinion specifically does not apply to investments in nonbusiness entities, such as estates, trusts, and individuals. The Division believes that transactions by mortgage bankers with affiliates, as defined herein, should be accounted for as described in the appropriate sections of paragraphs .36 through .41.

**.36** The Division considered accounting for sales of mortgages (other than those held for long-term investment) by a mortgage banker to an affiliated company by recording such sales at (a) the cost basis on the records of the mortgage banker, (b) at the agreed intercompany sales price, or (c) the carrying value (lower of cost or market).

**.37** Generally, transactions between affiliated companies should not result in the reporting of gains or losses, as discussed in ARB No. 51, "... any intercompany profit or loss on assets remaining within the group should be eliminated." This principle supports the recording of sales of mortgages to affiliated companies at the mortgage bankers' cost basis. However, particularly when the market value of the mortgages being sold is

less than the cost basis, this method tends to disguise the mortgage banker's marketing results. Since the agreed intercompany sales price represents the cash flow reality, support also exists for recording the transaction at this amount. However, for an affiliated group such a sales price may not represent the economic facts and may reflect elements more akin to capital contributions or dividends than to realized gains or losses. The Division, therefore, believes that for transactions with affiliates neither the cost basis nor the agreed sales price basis adequately reflects the nature of the mortgage banker's business.

**.38** The Division believes that the separate financial statements of mortgage bankers should reflect the economic conditions within which the mortgage banker operates. In addition, transfers to affiliates are usually similar in nature to transfers to the long-term investment category, and the Division believes both transactions should be accounted for in the same manner. Conversely, however, generally accepted accounting principles require the postponement, except in rare circumstances, of recognition of profits until sale to unrelated third parties. Consequently, the Division believes that sales of mortgages to an affiliate by a mortgage banker should be recorded at the lower of cost or market value as determined at the measurement date, which is the date a management decision has been reached that a sale between affiliates will occur. Although not susceptible of precise definition, determination of the date such a decision is reached should be based upon, at a minimum, formal approval by the appropriate investment authorities of the purchaser, issuance of a binding commitment to purchase the mortgages, and acceptance of the commitment by the selling mortgage banking firm. The amount of any loss should be computed as the difference between market value, calculated in accordance with paragraphs .25 through .32, and the cost of the loans. Since any marketing loss was incurred by the mortgage banker prior to the sale to the affiliate, such loss should not be eliminated in consolidation.

**.39** Any amounts paid by an affiliated company in excess of the lower of cost or market value at the measurement date should not be recorded by the mortgage banker as income and any amounts paid which are less than the lower of cost or market value should not be recorded as a loss.

**.40** On rare occasions, a mortgage banker may originate a particular class of loans or all loans exclusively for an affiliated



company. In such instances the mortgage banker is acting as agent for the affiliate and such loan transfers should be recorded at the mortgage banker's acquisition cost. The Division does not believe, however, that such an agency relationship exists in the case of "right of first refusal" contracts or similar types of agreements or commitments. While the mortgage banker may earn a fee for originating loans as an agent for an affiliated party, the risks, including the marketing risks, associated with ownership of the loans should be borne by the affiliate, not the mortgage banker, for any agency relationship to exist.

.41 In accounting for the sale of mortgages between affiliated companies, there is a presumption that the purchasing company intends to hold purchased mortgages as long-term investments. If repurchase agreements exist (for example, resales of such mortgages by the affiliated purchaser either to the mortgage banking affiliate or to other permanent investors), such presumption may not be sustainable. In this event, consideration should be given to accounting for the transactions as intercompany loans collateralized by the mortgages. In such cases the mortgage banker should continue to value the mortgages as loans held for sale.

## **CLASSIFICATION OF BALANCE SHEETS**

### **Current Industry Practice**

.42 Practices vary within the mortgage banking industry with respect to the preparation of classified or unclassified balance sheets. Historically, government agencies and some investors have requested (but not always required) balance sheets showing current and non-current assets and liabilities. Many mortgage bankers, however, have published non-classified balance sheets in their annual reports, arguing that ordinary working capital ratios are not meaningful tests of mortgage banker financial statements. For most mortgage bankers, a large portion of their short-term liabilities are represented by bank borrowings collateralized by specific mortgage notes receivable. The receivables were purchased using funds obtained from the notes collateralized by the receivables and the notes will be paid off from the funds received from the sale of the receivables. The Mortgage Bankers Association has recently made the following recommendation to the Department of Housing and Urban Development:

**“Elimination of References to Current Assets  
and Liabilities and Net Working Capital in  
FHA Form 2001-K**

“We suggest references to current assets and liabilities and net working capital be deleted from Form 2001-K. Accounting Research Bulletin No. 43, issued by the American Institute of Certified Public Accountants states:

‘. . . In the past, definitions of current assets have tended to be overly concerned with whether the asset may be immediately realizable.

‘(The current) tendency (is) for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations and less upon the debtors’ ability to pay in case of liquidation. It should be emphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business.’

“Generally, the existence of a normal operating cycle is the major prerequisite for requiring classification of a company’s balance sheet; conversely, where normal operating cycles are not identifiable, the presentation of current asset and liability classifications may not be meaningful. Such is often the case where primarily investing and financing activities are involved. In these cases, due to the direct financing relationship of a substantial portion of total assets to total liabilities, the flow of resources through a normal cycle is unidentifiable. This is also true in very long cycle industries, such as the land development industry. Most mortgage and construction loans of approved mortgagees are not due within one year. In addition, it is reasonable to assume that repayments on loans will generally be used to curtail direct financing activities or be invested in new loans. Also, the general practice of an approved mortgagee is to repay his short-term notes through the specific application of cash received from the sale of his mortgage loan inventory.

“Industry practices for Real Estate Investment Trusts, Banks, Finance Companies and Savings and Loan Associations have eliminated classifications for current assets and liabilities in financial statements. In addition, an increasing number of mortgage banking companies are issuing financial statements without these classifications.”

**The Division’s Position**

**.43** The Division concurs with the recommendation of the Mortgage Bankers Association to the Department of Housing and Urban Development. However, classified balance sheets are also acceptable. The mortgage banker should distinguish in either type of balance sheet between mortgages held for sale and mortgages held for investment, if any. The notes to the financial state-

ments should disclose to the reader of such financial statements sufficient data to permit the proper evaluation of a company's financial position and results of operations.

## APPENDIX A: SURVEY OF ACCOUNTING LITERATURE

### Basis of Valuation

.44 The Division found in existing pronouncements of the American Institute of Certified Public Accounts and the Financial Accounting Standards Board no definitive guidance on classifying the balance sheet or valuing the loans held for sale of a mortgage banking company. The Division also examined recent pronouncements on applicable general principles, industry audit guides for related industries, and the suggested chart of accounts and sample financial statements published by the Mortgage Bankers Association for guidance. The following paragraphs summarize the applicable literature.

.45 The concepts of measurement bases and timing of recognition of effects of transactions are discussed in APB Statement No. 4, Paragraph 35. Measurement bases are described as follows: "Several measurement bases are used in financial accounting, for example, net realizable value (receivables), lower of acquisition cost and present market price (inventories), and acquisition cost less accumulated depreciation (plant and equipment). Financial statements in general do not purport to reflect the current value of the assets of the enterprise or their potential proceeds on liquidation under present generally accepted accounting principles." The timing of effects of transactions are described as follows: "The effects of transactions and other events on the assets and liabilities of a business enterprise are recognized and reported in the time periods to which they relate rather than only when cash is received or paid."

.46 Paragraph 160 discusses immediate expense recognition as follows:

*"Immediate recognition.* Some costs are associated with the current accounting period as expenses because. . . (2) costs recorded as assets in prior periods no longer provide discernible benefits. . . The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefits be charged to expense."

Paragraph 171 describes another underlying principle as follows:

*“Conservatism.* Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost or market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles.”

**.47** Principles of resource measurement are discussed in APB Statement No. 4, Paragraph 70:

“Resources are measured in terms of money through money prices, which are ratios at which money and other resources are or may be exchanged. Several types of money prices can be distinguished based on types of markets (purchase prices and sales prices) and based on time (past prices, present prices, and expected future prices). Four types of money prices are used in measuring resources in financial accounting.

1. *Price in past purchase exchange of the enterprise*

This price is usually identified as historical cost or acquisition cost because the amount ascribed to the resource is its cost, measured by the money or other resources exchanged by the enterprise to obtain it.

2. *Price in a current purchase exchange*

This price is usually identified as replacement cost because the amount ascribed to the resource is measured by the current purchase price of similar resources that would now have to be paid to acquire it if it were not already held or the price that would now have to be paid to replace assets held.

3. *Price in a current sale exchange*

This price is usually identified as current selling price because the amount ascribed to the resource is measured by the current selling price of the resource that would be received in a current exchange.

4. *Price based on future exchanges*

This price is used in several related concepts—present value of future net money receipts, discounted cash flow, (discounted) net realizable value, and value in use. Each indicates that the amount ascribed to the resource is measured by the expected net future money flow related to the resource in its present or expected use by the enterprise, discounted for an interest factor.”

**.48** Principles of measuring and recording unfavorable events are discussed in Paragraph 183:

- “S-5. *Unfavorable external events other than transfers recorded.* Certain unfavorable external events, other than transfers, that decrease market prices or utility of assets or increase liabilities are recorded.”
- “M-5. *Measuring unfavorable events.* The amounts of those assets whose decreased market price or utility is recorded are adjusted to the lower market price or recoverable cost resulting from the external event.”
- “S-5B. *Decline in market price of certain marketable securities.* If market price of marketable securities classified as current assets is less than cost and it is evident that the decline is not due to a temporary condition a loss is recorded when the price declines.”
- “M-5B. *Measuring losses from decline in price of marketable securities.* The loss on a price decline of marketable securities is measured by the difference between the recorded amount and the lower market price.”
- “S-5E. *Decline in market prices of noncurrent assets generally not recorded.* Reductions in the market prices of noncurrent assets are generally not recorded until the assets are disposed of or are determined to be worthless.”

**.49** However, the principle of non-recognition of declines in market prices of non-current assets is modified with respect to long-term investments in the AICPA Statement on Auditing Standards No. 1, Section 332.03: “With respect to the carrying amount of investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor. The independent auditor should, therefore, also examine sufficient competent evidential matter to the extent he deems necessary to determine whether such a loss in value has occurred.”

**.50** Since mortgage loans held by mortgage bankers have characteristics of both security investments and inventory, and since, while heretofore an extremely rare occurrence, it is possible some mortgage bankers may hold loans for extended periods, the Division further reviewed accounting literature for applicable principles relating to short and long-term investments and inventories.

**.51** The AICPA Industry Audit Guide *Audits of Banks*, page 42, describes principles relating to bank security investment (gen-

erally bonds, but often mortgages also) as follows: "With relatively few exceptions securities held by banks are of investment grade. If they are held to maturity, they will be redeemed at an amount equal to their amortized cost. Accordingly, it is not customary practice for banks to provide specifically in their accounts for unrealized depreciation in the investment portfolio. This practice appears to be sound. Banks which are dealers in securities, however, should carry their trading account securities, which are in effect inventories, at the lower of cost or market."

### Definition of Lower of Cost or Market

.52 Inventory and inventory pricing is discussed in ARB No. 43, Chapter 4, as follows:

*"Statement 1—The term inventory is used herein to designate the aggregate of those items of tangible personal property which are held for sale in the ordinary course of business."*

*"Statement 5—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."*

### Discussion

"8. Although the cost basis ordinarily achieves the objective of a proper matching of costs and revenues, under certain circumstances costs may not be the amount properly chargeable against the revenues of future periods. A departure from cost is required in these circumstances because cost is satisfactory only if the utility of the goods has not diminished since their acquisition; a loss of utility is to be reflected as a charge against the revenues of the period in which it occurs. Thus, in accounting for inventories, a loss should be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. The measurement of such losses is accomplished by applying the rule of pricing inventories at cost or market, whichever is lower. This provides a practical means of measuring utility and thereby determining the amount of the loss to be recognized and accounted for in the current period."

*"Statement 7—Depending on the character and composition of the inventory, the rule of cost or market, whichever is lower may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each*

major category). The method should be that which most clearly reflects periodic income.

### *Discussion*

"11. The purpose of reducing inventory to market is to reflect fairly the income of the period. The most common practice is to apply the lower of cost or market rule separately to each item of the inventory. However, if there is only one end-product category the cost utility of the total stock—the inventory in its entirety—may have the greatest significance for accounting purposes. Accordingly, the reduction of individual items to market may not always lead to the most useful result if the utility of the total inventory to the business is not below its cost. This might be the case if selling prices are not affected by temporary or small fluctuations in current costs of purchase or manufacture. Similarly, where more than one major product or operational category exists, the application of the *cost or market, whichever is lower* rule to the total of the items included in such major categories may result in the most useful determination of income.

"12. When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market equally in excess of cost, such components need not be adjusted to market to the extent that they are in balanced quantities. Thus, in such cases, the rule of *cost or market, whichever is lower* may be applied directly to the totals of the entire inventory rather than to the individual inventory items, if they enter into the same category of finished product and if they are in balanced quantities, provided the procedure is applied consistently from year to year."

### **Accounting for Transactions with Affiliates**

.53 The basic accounting theory regarding the appropriate accounting for transactions among affiliated companies was stated in ARB No. 51, Paragraph 1, which states:

"The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies."

.54 In addition, APB Opinion No. 18 concluded in Paragraph 17:

"The equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency."

.55 The guidelines for consolidation procedure as set forth in ARB No. 51, Paragraph 6, are:

"In the preparation of consolidated statements, intercompany balances and transactions should be eliminated. This includes intercompany open account balances, security holdings, sales and purchases, interest, dividends, etc. As consolidated statements are based on the assumption that they represent the financial position and operating results of a single enterprise, such statements should not include gain or loss on transactions among the companies in the group. Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated."

.56 The above principle was extended to non-subsidiary investments by Paragraph 19.a of APB Opinion No. 18 as follows:

"Intercompany profits and losses should be eliminated until realized by the investor or investee as if a subsidiary, corporate joint venture or investee company were consolidated."

.57

## **APPENDIX B: GLOSSARY**

*Commercial Loans*—Loans on income producing property, such as apartments, shopping centers, office buildings and manufacturing facilities.

*Commitment Fee*—Any fee paid by a potential borrower to a potential lender for the lender's promise to lend money in the future. The issuer may or may not expect to fund the commitment.

*Construction Loans*—Loans which finance the acquisition of sites for and the construction of residential and income-producing properties. Such loans are usually repaid with the proceeds from the permanent financing.

*FNMA*—Federal National Mortgage Association—An investor-owned corporation which acts as a secondary market for mortgage loans. Formerly a U.S. Government agency, this corporation frequently performs a counter-cyclical function, supplying funds for the mortgage market when



other investor funds are limited and selling mortgages when other investor funds are plentiful.

**GNMA**—Government National Mortgage Association—A U.S. Government agency which guarantees certain types of mortgage banker debt securities and which funds and administers certain types of low income housing assistance programs.

**Loan Commitment**—A written promise by a lender to loan a certain sum at a certain rate of interest.

**Origination Fee**—A fee, normally expressed as a percentage of the principal balance of a loan, charged to compensate the mortgage banker for taking a loan application, obtaining an investor commitment, making property inspections and performing other services related to originating a mortgage loan.

**Residential Loans**—Loans on one to four family living units.

**Servicing Fee**—A fee, normally expressed as a percentage of the principal balance of a mortgage loan, charged by a mortgage banker for performing the loan administration functions.

.58

### **APPENDIX C: APPLICATION OF LOWER OF COST OR MARKET METHOD ON AGGREGATE BASIS TO LOANS HELD FOR SALE**

	Stated Loan Interest Rate	Loan Principal Balance	Acquisition Cost	Market Value (A)	Carrying Value
Loan A	9 %	\$10,000	\$ 9,600	\$10,000	
Loan B	8½	10,000	10,000	9,600	
Loan C	9½	10,000	10,500	10,400	
Loan D	8	10,000	9,500	9,200	
Loan E	8	10,000	9,800	9,200	
Loan F	8½	10,000	9,200	9,600	
		<u>\$60,000</u>	<u>\$58,600</u>	<u>\$58,000</u>	<u>\$58,000(2)</u>

Note A—Based on long-term interest rate of 9%

#### **COMPUTATIONAL NOTES**

- (1) Based on an average residential loan life of 12 years, a 1% difference between stated loan interest rate and current

market interest rate equals approximately 8% of loan principal balance.

- (2) The carrying value of the loans for a mortgage banker using the identified loan method of applying the lower of cost or market basis would be \$57,200, with Loan A valued at its cost, \$9,600, and Loan F valued at its cost of \$9,200, since unrealized gains are not used to offset unrealized losses in this method.

## ACCOUNTING STANDARDS EXECUTIVE COMMITTEE

December 30, 1974

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Stanley J. Scott, Chairman	Irving B. Kroll
Hector R. Anton	Raymond C. Lauver
Philip B. Chenok	James J. Quinn
Harold Cohan	Harry F. Reiss, Jr.
William H. Conkling, Jr.	George R. Vogt
Donald J. Hayes	Charles A. Werner
Robert S. Kay	Arthur R. Wyatt
	Alvin Zuckerkorn

## ACCOUNTING STANDARDS TASK FORCE ON MORTGAGE BANK PORTFOLIOS

December 30, 1974

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Alvin Zuckerkorn, Chairman	Joseph Hearne
Thomas Asson	Robert Hermance
	Robert McMullen

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➡ The next page is 17,751 ←

**Section 10,050**

# **Statement of Position 75-1**

## **Revenue Recognition When Right of Return Exists**

**[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

January 17, 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 Revenue Recognition When Right of Return Exists. 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.

As indicated in the introduction, the Statement is intended to apply, broadly speaking, only to situations in which personal property may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate consumer or by a party who resells the property to others. Questions have arisen as to the proper accounting in these circumstances and several alternative accounting methods are presently being followed which can produce materially different results.

This Statement takes the position that if a seller is exposed to the risks of ownership through return of the property, the transaction should not be recognized currently as a sale unless all of certain specified conditions are met. One of those conditions is that the amount of future returns can be reasonably predicted. The Statement sets forth factors to be considered in determining whether or not that condition is met.

The Statement also takes the position that if sales are recognized because the specified conditions are met, provision should be made immediately for any costs or losses which may be expected in connection with any returns.

The Division would appreciate being advised as to the Board's proposed action on these recommendations.

Sincerely yours,

  
STANLEY J. SCOTT  
Chairman

Accounting Standards Division

➡ The next page is 17,753. ⬅



**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.

**REVENUE RECOGNITION WHEN RIGHT  
OF RETURN EXISTS****INTRODUCTION**

.01 This Statement of Position presents recommendations on accounting for revenue in certain sales transactions when the right to return the property exists. It was prepared on behalf of the Accounting Standards Division by the Accounting Standards Executive Committee and represents the conclusions of at least a majority of that Committee.

.02 This Statement of Position applies only to situations in which personal property may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate consumer or by a party who resells the property to others. It is not intended to cover accounting for revenue in service industries when part or all of the sales proceeds may be returned under cancellation privileges. In addition, the conclusions expressed herein are not intended to apply to transactions involving real estate or lease arrangements, since such transactions are the subject of AICPA Industry Accounting Guides and Opinions of the Accounting Principles Board.

.03 Situations also exist in which, because of unusual price concessions, sales discounts, collection losses, etc., the economic results of the transaction are substantially the same as if the property were returned. Although transactions of this type are

beyond the scope of this Statement, the conclusions in this Statement of Position may be equally appropriate in determining the proper accounting for such transactions. These other transactions are mentioned later in this Statement under "Discussion" and, in Appendix A, under "Selected Examples of Industry Practice."

.04 The Division recognizes that this is only one part of the broad conceptual problem related to the measurement and reporting of revenue. Presumably, that problem will be considered by the FASB when it studies the "fundamentals of accounting and reporting," an element of its project, *Conceptual Framework for Financial Accounting and Reporting*.

.05 This Statement of Position has been prepared and issued because questions have been raised as to the proper accounting when the right of return exists and several alternative accounting methods are presently being followed which can produce materially different results. The Division believes it is necessary and desirable to narrow the available alternatives in this area.

### GENERAL BACKGROUND

.06 It is the practice in some industries for customers to be given the right to return goods to the seller under certain circumstances. In the case of sales to the ultimate consumer, the most usual circumstance is that the consumer is dissatisfied with the goods. For sales to customers engaged in the business of reselling the goods, the most usual circumstance is that the customer has not been able to resell the goods to another party. Goods usually can be returned for a full refund of the purchase price, for a credit applied to amounts owed or to be owed for other purchases, or for exchange for other goods.

.07 The right of return can exist either as a matter of contract or as a matter of practice. Such arrangements with customers acquiring for resale are often referred to as "guaranteed sales," and may also be consignments.

.08 Sometimes the returns occur very soon after a sale is made, as in the newspaper and perishable food industries. In other cases a longer time cycle is involved, such as with book publishers and equipment manufacturers. The rate of return varies considerably, from the low percentage of returns usually found in the food industry to the very high rate often found in

the publishing industry, where frequently more than half of the items delivered to customers for resale may be returned.

.09 Situations that pose particular problems arise when sales result in significant "overstocking" by customers acquiring goods for resale. In such situations, the recognition of revenue in one period is often followed by substantial returns in a later period.

.10 In practice, accounting for revenue when the right of return exists has varied considerably among companies and among industries. In some cases no sale is recognized until the goods are unconditionally accepted. In other cases a sale is recognized immediately and an allowance for estimated returns is provided. In still other cases a sale is recognized immediately without providing an allowance for returns and, instead, sales returns are recognized at the time returns take place.

### THE DIVISION'S CONCLUSIONS

.11 The Division believes that sales transactions should be analyzed to determine their economic substance. If the seller is exposed to the risks of ownership through return of the property, it should be presumed that the transactions should not be recognized currently as sales unless *all* of the following conditions are met (and the usual conditions for recording sales not involving right of return have also been satisfied):

- (1) The seller's price to the buyer is substantially fixed or determinable at the date of exchange.
- (2) Either the buyer has made full payment, or the buyer is indebted to the seller and payment is not contractually or implicitly excused until such time as the product is resold.
- (3) The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the property.
- (4) The buyer acquiring for resale has economic substance apart from that provided by the seller; that is, the buyer is not a straw party or conduit.<sup>1</sup>

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<sup>1</sup> This condition is concerned primarily with buyers which exist "on paper," i.e., which have little or no physical facilities, employees, etc. It is intended to prevent companies from recognizing sales to parties which the sellers have established primarily for the purpose of recognizing such sales.

- (5) The seller does not have significant obligations for future performance to bring about resale of the property by the buyer.
- (6) The amount of future returns can be reasonably predicted.

.12 The Division also believes that if sales are recognized because the conditions are met, provision should be made immediately for any costs or losses which may be expected in connection with any returns. Amounts of sales revenue and cost of sales reported in the income statement should exclude the portion for which returns are expected. Transactions for which sales recognition is postponed should be recognized as sales when the return privilege has substantially expired. The seller's gross sales and related accounting policies should be disclosed in the financial statements whenever product returns are a significant factor in the seller's operations.

.13 The ability to make a reasonable prediction of the amount of future returns is dependent on the existence of many factors. While it is not feasible to make an arbitrary determination of when a reasonable prediction can be made, since circumstances vary from one case to the next, the existence of the following factors would appear to impair the ability to make a reasonable prediction:

- (1) The susceptibility to significant external factors, such as technological obsolescence or swings in market demand.
- (2) Relatively long periods of time before it can be determined that a particular item of property is not returnable.
- (3) Absence of historical experience with similar types of sales of similar items of property, or inability to apply such experience because of changing circumstances.
- (4) Absence of a large volume of relatively homogeneous transactions.
- (5) A significant chance that the selling company's marketing policies and relationships with its customers could change.



.14 Of course, no list can be complete; only general guidelines can be established. Further, the existence of one or more of the above factors may not be sufficiently significant in light of the significance of other factors to prevent making a reasonable prediction.

.15 A reasonable prediction does not require complete knowledge of future events, since it is usually not possible to know with certainty what will occur in the future. It is well established that "Future events and their effects cannot be perceived with certainty."<sup>2</sup> Thus, a reasonable prediction permits some room for doubt.

## DISCUSSION

### Survey of Accounting Literature

.16 Pervasive revenue recognition principles are set forth in APB Statement No. 4. Paragraph 153 states that "The realization principle requires that revenue be earned before it is recorded." APB Opinion No. 10 states that "revenues should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts" but provides for recognizing revenue on the installment or cost recovery methods where there is no reasonable basis for estimating the degree of collectibility of revenue. This concept, and others, are discussed in more detail in the AICPA Industry Accounting Guides, *Accounting for Retail Land Sales*, *Accounting for Profit Recognition on Sales of Real Estate*, *Accounting for Motion Picture Films* and *Accounting for Franchise Fee Revenue*, and in FASB Statement No. 13. [As amended, effective January 1, 1977, by FASB Statement No. 13.]

.17 Appendix B presents pertinent quotations from these documents.

### The Realization Principle

.18 Accountants have different views as to the realization principle and the point at which revenue should be recognized in income statements. The spectrum of views can be classified as set forth below.

- (1) Recognition of increments in value ("holding gains").

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<sup>2</sup> APB Opinion No. 20, Paragraph 10.

- (2) Recognition of increments in value tied to an event, usually a transaction with outside parties.
- (3) Recognition of revenue when there is a transaction with outside parties and the seller has no further obligations or performance requirements.
- (4) Recognition of revenue when an unconditional right to receive the consideration of an exchange exists but there is some uncertainty as to the ultimate amount of consideration to be received.
- (5) Recognition of revenue only when reasonable assurance exists that the consideration will be received and it is not refundable.

.19 The point at which revenue is recognized in particular circumstances is sometimes resolved based on the availability of objective evidence which can be subjected to audit, on the extent to which additional conditions must be fulfilled or satisfied, or on the relative degree of uncertainty involved. Selection of decision criteria is also dependent upon whether the accounting is for a single transaction or a large volume of similar transactions.

### **Types of Risks Which Might be Retained by the Seller**

.20 The specific problem to which this Statement of Position is addressed is the problem of revenue recognition when the right of return exists. However, it should be noted that a seller might retain the risks of ownership under a variety of arrangements and types of transactions, some of which do not involve the return of the product, as summarized below.

#### *Product Returned*

- (1) Return if buyer does not resell product.
- (2) Return if buyer is dissatisfied with product.
- (3) Return under a trade-in privilege, granted to give buyer protection from a decline in the value of the product.
- (4) Return resulting from default by buyer on payment of purchase price.
- (5) Return resulting from option of buyer to compel seller to repurchase product.

*Product Not Returned*

- (1) Warranties or guarantees as to performance or quality.
- (2) Collection losses attributable in whole or in part to losses in collateral value of the product sold.
- (3) Price rebates or other concessions.

.21 The risk of loss to which the seller is exposed might be quantitatively the same in any of the above situations. Further, the nature of the risk might be the same regardless of the form of the transaction through which a loss is realized. For example, a significant decline in the market value of the property could result in the return of the property to the seller. In that case, the seller's loss would be equivalent to the loss in market value and perhaps, in addition, costs associated with the return and disposition of the property. If the property is not returned, the seller might nevertheless incur a loss of the same or greater magnitude; for example, in the form of a collection loss.

.22 Risks can be categorized generally between those which are attributable to internal factors, such as manufacturing defects, and those which are attributable to external factors, such as market demand for a product. To a certain extent these factors are closely related. For example, inferior quality can result in low demand for the product. Because of the interrelationship of factors contributing to the risk of loss, it is possible that different types of losses could all be attributable to a single cause. Poor quality manufacturing could result in expenses under warranties, returns of products because of user dissatisfaction, returns of products not resold, losses in the collection of receivables or in the guarantee of buyer financing. Thus, it is reasonably evident that the transaction through which a loss is sustained is not necessarily indicative of the nature of all of the risks to which the seller is exposed or of the cause of the loss.

.23 Frequently, sellers limit their exposure to loss when the product is not returned. For example, limits are placed on warranty coverage, and down payments reduce exposure to credit loss in certain financing arrangements. When a product is returned, however, the exposure to loss may be more significant for a given item of property.

.24 Allowances are generally provided for estimated warranty expenses and estimated losses on the collection of receivables.

Allowances are also often provided to recognize estimated returns. The use of allowances for returns is questionable, however, if the uncertainties and losses are very significant. Instead, it may be necessary to postpone revenue recognition.

**.25** The return of property sold is usually a transaction in which the buyer receives either cash, a credit to be applied to amounts owed the seller, or another piece of property. The loss to the seller will be the same in all cases with respect to the return. The seller will have taken back property of lower value (to the seller) than the amount of refund and will incur handling costs and perhaps costs to restore the property to a salable condition.

**.26** If there has been an exchange of properties, the loss to the seller can be considered to be reduced by profit attributable to the property issued, particularly if the buyer is obligated to accept property rather than cash or a credit.

### **Accounting Alternatives**

**.27** A seller may retain significant risks of ownership if there is a right to return the property. In line with the accounting treatment accorded in certain other situations in which risks are retained, it may not be appropriate to record the transaction as a sale until circumstances assure that the buyer will not return the property. Rationale for this accounting treatment may be summarized as follows:

- (1) Realization has not occurred if a "sale" is not an event with economic significance, and other significant economic events must take place in order to provide reasonable assurance that the seller will receive the sales proceeds.
- (2) Realization has not occurred if there is a significant chance that events which are beyond the control of the seller, such as rapid technological change or large swings in market demand, could occur that would result in a loss of sales proceeds.
- (3) Transactions in which the buyer has an unconditional right of return may be in substance consignments and should be accounted for as such.
- (4) Where significant risks of ownership are retained by the seller, objective, verifiable evidence regarding

amounts ultimately to be realized as sales proceeds usually cannot be obtained.

**.28** Alternatively, recognition of a sale may be appropriate in many circumstances provided an allowance is established which reduces the amount of sales recorded for estimated returns. Arguments in favor of this accounting approach are summarized as follows:

- (1) Financial accounting involves the estimation process in many areas. Without estimates financial statements would be less useful and instead would require numerous judgments to be made by the users of financial statements regarding the economic progress of a business entity when in fact management may well be in a better position to make such judgments.
- (2) When a sale takes place, frequently many risks are retained by the seller even if the property will not be returned. For example, the retention of a credit risk often includes the retention of risks of ownership in the property sold. Guarantees of quality also result in retention of some risks of ownership. Provided reasonable estimates can be made, retention of these types of risks generally should not preclude recording sales as deliveries to customers are made.
- (3) The delivery of property to a buyer, even though subject to return at a later date, is often a significant economic event which entails agreement by the buyer to accept the property and frequently involves passage of title. Thus, it is an event which has an effect on the cash generating ability of the seller, measurement and reporting of which is considered an important objective of financial statements.
- (4) If a loss occurs in a subsequent period which was not reasonably foreseeable, it should be given accounting recognition in the period in which it occurs as an economic consequence of activities of that period. A loss which was not reasonably foreseeable should not preclude recognition of a sale.

**.29** The choice between these two accounting alternatives appears to be highly dependent upon the degree to which returns of property can be predicted. If prediction is not possible because

of the existence of various factors which are highly uncertain, the second alternative, that of recording the sale together with an allowance for estimated returns, is not a practicable approach. On the other hand, if returns can be reasonably predicted, the alternative of not recording a sale seems to postpone unreasonably an important accounting measurement and fails to give recognition to the portion of sales as to which there is reasonable assurance that the property will not be returned.

.30 A third accounting alternative is to record sales without an allowance for estimated returns and to account for returns as they are received. Arguments for this alternative are the following:

- (1) Arguments (3) and (4) for the second alternative above.
- (2) Returns are accepted to maintain relationships with customers or market strength, and therefore represent a discretionary period cost similar to advertising.
- (3) The effect of returns is often insignificant, especially if another item of property is exchanged and gross profit is not lost.

.31 This accounting alternative is acceptable only if future returns and losses are expected to be clearly insignificant.

## **APPENDIX A: SELECTED EXAMPLES OF INDUSTRY PRACTICE**

.32 These examples are presented in this Appendix only to demonstrate the variety of circumstances and accounting practices that presently exist. This is not an all-inclusive list of those industries in which different accounting alternatives are applied in practice, nor is this Statement of Position intended to be restricted to the industries described herein.

### **Perishable Foods**

.33 Perishable foods, such as bakery products, whether sold to a grocery store, restaurant or institution, are usually sold with the right to return any stale or excess product. For the most part, sales are recorded at the time of delivery with no allowance for returned goods provided. Returns are accounted for as reduc-

tions of sales in the period in which the goods are returned. This practice is based on the following industry characteristics :

- (1) Orders are based on past experience and knowledge of requirements; the volume of returns is, therefore, not significant in relation to sales.
- (2) Some perishable foods, such as stale bakery goods, may be disposed of at discount prices.

.34 To a limited degree, some companies provide allowances for returns when sales are reported. The short time between sale and return permits an easy determination of the amount of allowance.

### **Rack Jobbers**

.35 Retailers often buy merchandise from distributors, known as "rack jobbers," who agree to inspect and restock retailers' shelves periodically with a variety of merchandise, usually within one or more broad classifications, e.g., cosmetics and drugs, records, soft goods. Rack jobbers often provide limited marketing services (for example, determining which brands and quantities should be placed on the retailer's shelves) and thus they act as both buyer and seller. Title usually passes upon delivery, at which time the retailer is billed.

.36 In most cases turnover is fast, with a relatively low rate of return. Sometimes returns are limited to defective merchandise or specifically priced products, both of which might be returned to manufacturers with little or no loss to the rack jobber. In such cases the removal of the product from the retailer's inventory is followed immediately by a replacement with other merchandise. Thus, the gross profit on the initial delivery is not considered to have been lost and an allowance for returns is often not established as it is not considered to be necessary.

.37 Sometimes rack jobbers must accept returns of slow-moving or seasonal merchandise, which may or may not be returned to manufacturers. In some instances allowances for returns are provided; in others, they are not.

### **Records and Tapes**

.38 Record and tape manufacturers generally sell products to distributors with exchange privileges, unlimited right of return, or limited right of return. Rights granted to distributors

are usually passed on to the retailers. Payment is usually required within sixty to ninety days. Although inventory held by retailers may be returned to manufacturers, the manufacturers and distributors usually have no information about retailer inventories. However, high volume and relatively stable rates of return have usually enabled companies to record allowances for returns with reasonable accuracy. This practice is followed by the majority of record companies. Rates of return vary according to type of product, but generally fall in the range of 15% to 30%.

### **Publishing**

**.39** Sales in the publishing industry are generally made on a fully returnable basis. In some cases, magazine and paperback shipments made to distributors usually produce an excess that will be returned. The fact that demand for publications often cannot be predicted with accuracy, and the fact that the time lag between the sale and return may be from three months to two years or more make the accounting problem more difficult.

Magazine returns from newsstands may be as high as 65%, returns of hard cover books may be as high as 25% and returns of paperback books may be as high as 60%. The distributorship agreement usually provides for advances to be paid to the publisher in installments with the final payment made at the settlement date.

**.40** Four methods of recording sales are found in the publishing industry.

- (1) Sales are recorded upon shipment and an allowance for returns is established. This practice is generally followed by publishers of paperbacks, hard cover trade books and magazines.
- (2) Sales are recorded upon shipment and returns are recorded when they are received. This practice is sometimes used by publishers of hard cover trade and textbooks, where lower rates of return are involved.
- (3) Sales are recorded using the consignment method; i.e., sales of those books remaining in the hands of distributors are not recorded. This method is not a common practice.
- (4) If a publisher has recently begun operations or has



no relevant experience in the marketing of its new titles, sales are not recorded until the settlement date with the distributor. This is not a common practice.

**.41** The allowance for returns is usually established using one of the following methods :

- (1) The allowance may be based on historical experience with respect to the percentage of returns over a reasonable period of time. These historical percentages are usually maintained by book title or category of title, or by magazine, and great weight is given to the trend of returns in the last months of the fiscal year. Use of historical data is usually combined with a review of returns actually received and the trend of returns after the balance sheet date.
- (2) For new titles, the reserve may be based on management's best estimate if there is sufficient prior experience to judge the success of a new book.

### **High-Unit-Cost Items**

**.42** Some manufacturers of certain high-unit-cost products (e.g., mobile homes, trucks, farm machinery, boats) who sell to independent dealers or distributors may be exposed to risks of ownership which may or may not involve return of products.

**.43** Financing and other arrangements between the manufacturers and independent dealers vary. In some cases, the manufacturers finance the dealers by providing credit terms that allow the dealers sufficient time to market the product to their customers before paying the manufacturer. The terms under these credit arrangements may or may not require identification of the specific product to be sold prior to remittance to the manufacturers. In other cases, financing is provided to the dealer under "floor plan" financing arrangements either by the manufacturer's captive finance subsidiary or by independent financial institutions. The manufacturer ordinarily guarantees amounts due the financial institutions in the event the dealer is unable to repay amounts borrowed. These financing practices may expose the manufacturer to a potentially significant risk of product returns depending upon other circumstances such as the financial soundness of the dealer and vulnerability of the product to sudden swings in market demand.

**.44** Additional existing practices can also influence the selection of an appropriate method of revenue recognition when potential return of a product is involved. For example, contractual arrangements sometimes provide that the manufacturer will grant significant price allowances to dealers for products which remain unsold after a stipulated period of time. In other cases, significant price concessions to dealers may be granted by the manufacturer even though no contractual obligation to do so exists. Another example relates to the variation in economic relationships and contractual arrangements between manufacturers and dealers. Some dealers may carry only the products of a particular manufacturer whereas others may merchandise the products of a number of manufacturers. Under certain contractual arrangements a manufacturer may impose strict constraints upon a dealer's marketing of the manufacturer's products such as requirements for the manufacturer's approval of customer price allowance, customer credit, advertising and promotional campaigns, etc. On the other hand, dealers in many cases have considerable flexibility in such matters.

**.45** Revenue recognition by manufacturers for sales of products to dealers generally coincides with the shipment or delivery of the products to the dealer. In some cases, manufacturers may "warehouse" the product for the dealer pending instructions from the dealer for shipment directly to its customer, for addition of customer directed accessories or for other reasons; however, revenue recognition generally coincides with the passage of title to the dealer in such cases.

**.46** The practice of establishing allowances for possible product returns coincident with revenue recognition from the sale varies widely. The determination of an allowance for returns is usually closely related to the periodic evaluation of the collectibility of receivables or the potential for loss arising from other financing arrangements because changes in demand factors may affect both receivable collectibility and potential returns. In rare instances, revenue is not recognized by the manufacturer until the time of sale by the dealer to the customer. The use of this method generally involves the overall consideration of many factors such as (1) floor plan or other arrangements which defer payment until resale of the product by the dealer, (2) extended periods of time over which dealer financing is offered (e.g., up to one year or more), (3) the offering of significant price allow-

ances and perhaps absorption of certain dealer costs on slow moving items, (4) a lack of consistent relationship between periodic shipments to the dealer and his ultimate sale to the consumer, and (5) the financial soundness of the dealer.

### **Toys and Sporting Goods**

.47 The business of manufacturing and selling toys and sporting goods is seasonal in nature. Often credit terms postpone payment by the buyer until the normal retailing period has begun. In many cases the buyers have the right to return unsold products to the manufacturers. However, many such companies select fiscal years which correspond closely to their natural business cycle and, as a result, the majority of the products which will ultimately be returned will have been returned before the financial statements for the year are issued.

.48 In these industries, the goods are also often returned not because of any contractual or other right, but because of late deliveries, substituted deliveries and similar operating problems. In some cases, although goods are not returned, the seller may also be exposed to the risks of ownership because discounts are permitted in lieu of return privileges. In most instances, sales are recorded upon shipment, although occasionally consignment accounting is used. If sales are recognized immediately the accounting for returns varies. Allowances are provided in some cases and, in other cases, returns are recognized only as they occur.

### **Industries Lacking Product Differentiation**

.49 Certain companies are characterized by the lack of product differentiation; that is, the company's products and those of its competitors are basically identical. A few examples are generic drugs, chemicals (fertilizer, polyethylene resins, etc.) and certain consumer goods (detergents, etc.). These companies, therefore, compete within the marketing area. In addition to granting a right of return, in some cases the seller retains the risks of ownership through advance sales, extended terms, price protection, etc. Practices are not uniform.

### **Sales to the Ultimate Consumer**

.50 The industry descriptions above are of sales primarily to wholesalers, distributors or retailers, and, as noted, goods may

be returned for a variety of reasons. In sales to the ultimate consumer, the consumer may be given the right of return for reason of dissatisfaction with the product. In most cases, a sale is recognized when the consumer obtains possession, and an allowance for returns may or may not be established.

## **APPENDIX B: SURVEY OF ACCOUNTING LITERATURE**

**.51** Pervasive revenue recognition principles are set forth in paragraph 150-153 of APB Statement No. 4:

“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.” (Par. 150)

“Revenue recognized under the realization principle is recorded at the amount received or expected to be received.” (Par. 151)

“Revenue is sometimes recognized on bases other than the realization rule. . . . Sometimes revenue is recognized at the completion of production and before 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 characteristics of unit interchangeability are reasons given to support this exception.” (Par. 152)

“The realization principle requires that revenue be earned before it is recorded.” (Par. 153)

**.52** APB Opinion No. 10 provides for recognizing revenue on the installment or cost recovery methods, under conditions in which there is no reasonable basis for estimating the degree of collectibility of revenue. Paragraph 12 of APB Opinion No. 10 reaffirms the statement in Chapter 1A of ARB No. 43, Paragraph 1, that “Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured.”

In making this reaffirmation the Opinion also states that the Board “believes that (otherwise) revenues should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts.”

**.53** The AICPA Industry Accounting Guide, *Accounting for Retail Land Sales*, states in Paragraph 13 that “The principle of realization presupposes that title will be transferred at or before the time of profit recognition. Delay in conveyance of title may occur in the real estate industry for a variety of reasons and

does not require deferring profit recognition for an otherwise acceptable transaction if the purchaser has the right to receive title when the receivable is paid or at the end of the normal contract period. Receipt of option deposits does not constitute a recordable sale under the realization principle.” The Guide goes on to state in Paragraph 15: “The Committee believes that recognition of the sale should be deferred until certain conditions are met that indicate that (a) the customer seriously intends to complete the contract and (b) the company is capable of fulfilling its obligations under the contract so that customers cannot later demand and receive refunds for failure to deliver.” The Guide sets forth three specific conditions which must be met in order to record contracts as sales. One of the conditions is that “The customer has made the downpayment and each regularly required subsequent payment until the period of cancellation with refund has expired. That period should be the longest of the period required by local law, established by company policy, or specified in the contract, regardless of whether refunds are available for simple notification, site visitation or otherwise.”

.54 The Guide sets forth conditions for distinguishing between the use of accrual and installment sales methods of accounting for revenue. In general, the conditions for use of the accrual method are based on minimum uncertainties with respect to ultimate collection of sales proceeds. Paragraph 20, Item (d), includes the condition that “Collection experience for the project indicates that collectibility of receivable balances is reasonably predictable. . . .” Paragraph 21 amplifies this by saying “The ability to predict collection results of current sales presumes satisfactory experience on prior sales of the type of land being currently marketed in the project over a sufficiently long collection period to indicate the percentage of sales that will be collected to maturity. Since different sales methods may result in different cancellation and collection experience, historical data available must include experience with respect to each type of sales method used, such as telephone sales, broker sales, site visitation sales, etc.”

.55 This is reiterated in Paragraph 22 which states, “Thus the Committee concludes that income should be recorded under the accrual method if the company’s collection experience can provide information (described in Paragraph 20(d)), that supports a reasonable prediction of whether the required percentage

of contracts will pay out to maturity and all other conditions are met. The Committee believes that condition (d) above is vital to provide assurance that the uncertainties regarding collectibility of the remaining receivables are minimized.”

**.56** The AICPA Industry Accounting Guide, *Accounting for Profit Recognition on Sales of Real Estate*, states in Paragraph 7, “Revenue (and profit) is conventionally recognized at the time an asset is sold, provided (a) the amount of the revenue is measurable . . . and (b) the earning process is complete or virtually complete—that is, the seller is not obliged to perform significant activities after the sale in order to earn the revenue.” In Paragraph 8, it is stated, “If no reasonable basis exists to estimate the collectibility of the sales price in a transaction, the installment or cost recovery method of accounting is appropriate.” This is followed in Paragraph 9 with the statement that “Uncertainty about collectibility of the sales price may require another method of accounting in which the effective date of the sale is deferred until the uncertainty is satisfactorily resolved.” The Guide also states in Paragraph 11 that “Economic substance should determine the timing of recognition, amount, and designation of revenue if the economic substance of a transaction differs from its legal form. . . . For example, a transaction that is in the legal form of a sale . . . may be in economic substance . . . a deposit on or an option to purchase the asset. . . .”

**.57** Paragraph 12 continues, “To be accounted for as a sale, a transaction should transfer from the seller to the buyer (a) the usual risks of ownership (for example, obsolescence, unprofitable operations, unsatisfactory performance, idle capacity and dubious residual value). . . . Any risk that is retained by the seller in the asset sold should be limited essentially to that of a secured creditor. Otherwise, accounting for a transaction other than as a sale is required.” Paragraph 56 of the Guide states the following:

“The Committee concludes that the following contractual provisions . . . require accounting for the transaction as a financing, leasing, or profit sharing arrangement:

“A seller has an obligation or an option to repurchase the property. . . .”

“A buyer has an option to compel the seller to repurchase the property.”

“A seller guarantees the return of the buyer’s investment. . . .”

.58 The AICPA Industry Accounting Guide, *Accounting for Motion Picture Films*, requires that revenue from films licensed for television not be recognized prior to the fulfillment of five conditions, one of which is that "Collectibility of the full license fee is reasonably assured," and another of which is that "The film has been accepted by the licensee in accordance with the conditions of the license agreement." The Guide further says, "Should options or other factors raise doubt about the obligation or ability to perform on the part of either party, revenue recognition should be delayed until such options or factors no longer exist. Insignificant factors, such as the delivery of a print of a previously accepted film, are not a sufficient basis for delaying revenue recognition." With respect to the acceptance condition the Guide states, "However, certain feature films included in a package may have ratings such that their eventual acceptance by the licensee is so questionable that it would be necessary to delay revenue recognition for such films until unconditionally accepted by the licensee."

.59 The AICPA Industry Accounting Guide, *Accounting for Franchise Fee Revenue*, indicates the conclusion that revenue should not be recognized until the franchisor "has no remaining obligation or intent—by agreement, trade practice or operation of law—to refund any cash already received or to excuse nonpayment of any unpaid notes . . . and . . . any other conditions which affect consummation of the sale transaction have been met."

[.60] [Superseded, effective January 1, 1977, by FASB Statement No. 13.]

ACCOUNTING STANDARDS EXECUTIVE  
COMMITTEE

January 17, 1975

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Stanley J. Scott, Chairman	Irving B. Kroll
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ACCOUNTING STANDARDS TASK FORCE ON  
REVENUE RECOGNITION WHEN RIGHT OF  
RETURN EXISTS

January 17, 1975

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Robert F. Richter,  
Chairman

Edmund R. Noonan  
Morton B. Solomon  
Robert N. Waxman

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➡ *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.

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

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\* 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.<sup>1</sup> In addition, the initial valuation method should be the same for foreclosed properties held for resale and those held as an investment.<sup>2</sup> 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.

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<sup>1</sup> 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.

<sup>2</sup> 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.<sup>1</sup> 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-

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<sup>1</sup> 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 × .7417) = .....	<u>\$25,960,000</u>
Present value of estimated future cash disbursements—	
\$416,667 × 11.3745 × 1.0000 = .....	\$ 4,739,000
\$250,000 × 11.3745 × .9052 = .....	2,574,000
\$ 83,333 × 11.3745 × .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—*Year 1*

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 .....	$(11.4958 \times .9234)$	$(11.7440 \times .9609)$
	<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

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\* Interest compounded monthly.

**ACCOUNTING STANDARDS DIVISION****Accounting Standards Executive Committee**

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 *The next page is 17,951.* 



**Section 10,070*****Statement of Position 75-3  
Accrual of Revenues and  
Expenditures by State and  
Local Governmental Units***

**[Proposal to Financial Accounting Standards Board to Amend  
AICPA Industry Audit Guide on Audits of State and Local Govern-  
mental Units]**

**AICPA****American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, N.Y. 10036 (212) 575-6200

July 31, 1975

Marshall S. Armstrong, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position, prepared by the AICPA Subcommittee on State and Local Governmental Auditing, proposes amendments to the AICPA Industry Audit Guide on Audits of State and Local Governmental Units which will clarify that part of Chapter 2 of the Guide which deals with accruals of revenues and expenditures by state and local governmental units.

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 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,

AICPA SUBCOMMITTEE ON  
STATE AND LOCAL GOVERNMENTAL AUDITING

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Gerald W. Hepp	Joseph G. Tonascia
	Benton B. Warder

cc: Securities and Exchange Commission

#### 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 or Subcommittees 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 or Subcommittee.

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.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Subcommittee 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 believes would be in the public interest.

## AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS

### Proposed Amendment to Industry Audit Guide

#### BACKGROUND INFORMATION

.01 The accrual basis of accounting is followed (with minor exceptions) by all funds other than budgetary funds of state and local governmental units. Budgetary funds (general, special revenue, and debt service funds) use the modified accrual basis of accounting. The AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*, summarizes the modified accrual basis as follows:

1. Revenues are recorded as received in cash except for
  - (a) revenues susceptible to accrual and
  - (b) material revenues that are not received at the normal time of receipt.
2. Expenditures are recorded on an accrual basis except for
  - (a) disbursements for inventory type items, which may be considered expenditures at the time of purchase or at the time the items are used;

- (b) prepaid expenses, which normally are not recorded;
- (c) interest on long-term debt, which should normally be an expenditure when due; and
- (d) the encumbrance method of accounting, which may be adopted as an additional modification.

.02 Although the Guide contains a discussion of the application of both the accrual and modified accrual bases of accounting to revenues and expenditures, questions have arisen in practice with respect to four problem areas: sales taxes, revenue sharing, vacation and sick pay, and interest accruals in special assessment funds. Accordingly, this Statement of Position has been issued to revise or clarify that part of Chapter 2 of the Guide dealing (a) with the modified accrual basis, and (b) with the concept "fully matured and not paid" as it pertains to interest accruals in assessment funds.

### REVENUES SUSCEPTIBLE TO ACCRUAL

.03 The Guide describes, on page 14, criteria to identify revenues susceptible to accrual, as follows:

Revenues considered susceptible to accrual are those revenues that are both measurable and available. In substance, "available" means that the item is a resource that can be used to finance the governmental operations during the year.

Few types of revenues in budgetary funds possess all of the characteristics essential to meet both criteria of being measurable and available, which are requisite to being considered susceptible to accrual.

Revenue sources that generally are not considered susceptible to accrual include those generated on a self-assessed basis, such as income taxes, gross receipts taxes, and sales taxes. Normally, such taxes would be recorded as revenue when received.

The Subcommittee believes the Guide should be amended to clarify the application of these criteria to sales taxes and to revenue sharing entitlements.

.04 Specifically, the Subcommittee believes that *Audits of State and Local Governmental Units* should be amended by inserting the following paragraphs immediately before the first full paragraph (beginning "Normally, when an item is billable...") on page 15:

The following paragraphs illustrate the application of these criteria.

Sales taxes collected by merchants but not yet required to be remitted to the taxing authority at the end of the fiscal year should not be accrued. However, taxes collected and held by one government agency for another at year end should be accrued if they are to be remitted in time to be used as a resource for payment of obligations incurred during the preceding fiscal year. To illustrate, when a state collects all sales taxes and within 60 days remits to cities and counties the amounts collected for them, amounts held by the state for allocation on June 30 should be accrued by cities and counties with a June 30 fiscal year end. However, taxes collected by merchants during June and prior months but not required to be remitted until after June 30 should not be accrued by the state, counties, or cities.

Revenue sharing entitlements are for the period from July 1 to June 30 and are received in four installments, the last of which is not received until July. This final installment, which is both measurable and available, should be accrued at June 30 as a resource of the fund accounting for the initial receipt of revenue sharing entitlements.

### VACATION PAY AND SICK PAY

.05 The Guide states, on page 16, that "Expenditures are recorded on the accrual basis. . . ." and goes on to discuss certain exceptions to that statement. The Subcommittee believes the Guide should be amended to permit state and local governmental units not to record the costs of vacation and sick leave at the time the benefits are accumulated.

.06 Specifically, the Subcommittee believes that *Audits of State and Local Governmental Units* should be amended by inserting the following paragraphs immediately before the last full paragraph (beginning "A summary of the modifications. . .") on page 16:

Governmental units, like commercial and other organizations, provide vacation and sick pay benefits to their employees. However, governmental units often have policies or contractual agreements which permit employees to accumulate unused vacation and sick pay over their working careers and to redeem such unused leave time in cash upon death or retirement or by extended absence immediately preceding retirement. Portions of amounts accumulated at any point in time can be expected to be redeemed before termination of employment. While such accumulations may be material in total, the effect on the

financial statements of any one year may be immaterial. However, the effect on any one year may become material if the governmental unit is required to liquidate the accrued amounts, e. g., because of a court action by employees.

Although governmental units generally should record expenditures on the accrual basis, the accounting for unused vacation and sick pay needs to be considered in light of the unique environment of governmental units. Budgetary funds of governmental units, unlike business entities, are not concerned with the principle of matching costs against associated revenues. Rather, a major interest of governmental financial statement users is the fiduciary responsibility of the governmental body for the revenues appropriated. Further, long-term debts of budgetary funds are not recorded as debts in the fund which will be making the requisite payments but rather in the long-term debt group of accounts.

Considering these factors and the nature of the accumulated unused vacation and sick leave, it is appropriate to disclose the estimated amount of such commitments in a footnote, if material, and not record the costs as expenditures at the time the leave is accumulated. If accumulated unused vacation and sick pay at the end of a fiscal year does not exceed a normal year's accumulation, footnote disclosure is not required.

### **INTEREST ACCRUALS IN ASSESSMENT FUNDS**

.07 The Guide states, on page 13, that "In special assessment funds, interest income on assessments receivable and interest expense on offsetting bonds payable or other long-term debt should not be accrued unless fully matured and not paid." The Subcommittee believes this statement should be clarified by a footnote, as set forth below:

This principle applies whether or not the date for payments to bondholders coincides with the date for collections from property owners; for example, if interest from property owners is due on March 1 and the corresponding payment to bondholders is payable on June 1, the entity would report as interest receivable on June 30 only the amounts still uncollected from property owners for the preceding March 1 and prior interest dates. The interest payable reported at June 30 should be only the amounts still payable to bondholders for the preceding June 1 and prior interest dates.

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➡➡➡ *The next page is 17,991.* ⬅⬅⬅

## Section 10,080

## ***Statement of Position 75-4 Presentation and Disclosure of Financial Forecasts***

August 1975

### **NOTES**

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. This Statement represents 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, cost accounting, and financial forecast presentation. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

The objective of this Statement of Position is to provide general information and guidance to members and others on the *Presentation and Disclosure of Financial Forecasts*.

### **INTRODUCTION**

.01 This Statement of Position on *Presentation and Disclosure of Financial Forecasts* has been issued by the Accounting Standards Division of the American Institute of Certified Public Accountants because greater interest is being shown in financial forecasts and projections<sup>1</sup> and they increasingly are being disseminated.

.02 Few companies publish forecasts or projections for general dissemination at present. Many companies, however, issue forecasts or projections to lenders, underwriters and prospective investors in connection with obtaining debt or equity financing. They are included in offering circulars for bond issues to finance the construction of hospitals, airports, sports arenas and other public facilities, as well as in offering circulars for limited partnership interests, particularly in real estate.

.03 The Securities and Exchange Commission has historically prohibited the inclusion of forecasts or projections in prospectuses and reports filed with it. However, the Commission has

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<sup>1</sup> See *Definitions*, pars. .05-.09.

proposed changes in that policy to permit companies to include certain statements regarding future operations in filings made pursuant to the Securities Act and the Exchange Act.<sup>2</sup>

.04 Other Divisions within the AICPA are concerned with related aspects of financial forecasts:

- a. *Guidelines for Systems for the Preparation of Financial Forecasts* have been issued by the Management Advisory Services Division (MAS Guideline Series Number 3, March 1975). The guidelines provide direction to the developers of forecasting systems and to the preparers of financial forecasts.
- b. The Auditing Standards Division is studying matters relating to a CPA's involvement with his client's financial forecasts and the appropriate reporting by a CPA on such forecasts.

### DEFINITIONS

.05 Common usage in practice has not developed complete agreement on the definition of certain terms such as *forecast*, *projection*, *feasibility study*, and *budget*. For purposes of this Statement of Position, certain definitions have been adopted and used throughout.

#### Financial Forecast

.06 A financial forecast for an enterprise is an estimate of the most probable financial position, results of operations and changes in financial position for one or more future periods.

In this context—

- a. "Enterprise" means an entity for which financial statements could be prepared in accordance with generally accepted accounting principles.
- b. "Most probable" means that the assumptions have been evaluated by management and that the forecast is based on management's judgment of the most likely set of conditions and its most likely course of action.

#### Financial Projection

.07 A financial projection for an enterprise is an estimate of financial results based on assumptions which are not necessarily the most likely. Financial projections are often developed as a response to such questions as "What would happen if?".

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<sup>2</sup> Securities Act Release No. 5581, April 28, 1975.



### **Feasibility Study**

.08 A feasibility study is an analysis of a proposed investment or course of action. A feasibility study may involve the preparation of financial projections and/or a financial forecast. A financial forecast may in turn be based on the results of a feasibility study used in the formulation of management's plans.

### **Budgets, Plans, Goals, and Objectives**

.09 Budgets, plans, goals, and objectives also involve elements of predicting the future. However, each tends to have elements which distinguish it from a financial forecast although, in some situations, each may be identical to a forecast. Budgets, plans, goals, and objectives may have some of the elements of targets or motivational hurdles. Budgets especially involve motivational, control, and performance evaluation considerations.

### **SCOPE OF STATEMENT**

.10 This Statement provides guidance as to presentation and disclosure for those who choose to issue information about the future described as *financial forecasts*. Nothing herein should be interpreted to mean that the publication of financial forecasts is recommended or that a financial forecast is deemed to be a part of the basic financial statements.

.11 Financial projections, feasibility studies, budgets, plans, goals, and objectives are generally prepared for special purposes and do not fall within the scope of this Statement of Position; financial forecasts contained within a feasibility study do.

.12 Recommendations as to presentation and disclosure of cash flow or tax basis forecasts also do not fall within the scope of this Statement of Position.

### **RECOMMENDATIONS ON PRESENTATION AND DISCLOSURE**

#### **Format**

.13 Financial forecasts preferably should be presented in the format of the historical financial statements<sup>3</sup> expected to be issued, but, at a minimum, the presentation should consist of certain specific information (see below) obtained from such a financial forecast.

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<sup>3</sup> The details of each statement may be summarized or condensed, so that only the major items in each are presented. The usual footnotes associated with historical financial statements need not be included as such. However, see *Assumptions*, pars. .19-.27, for additional comments.

.14 Financial forecasts presented in the format of the historical financial statements expected to be issued would facilitate comparisons with results experienced in prior periods and with results actually achieved in the forecast period(s). However, given the lack of experience of most enterprises in issuing financial forecasts, there is reason to consider, for the present, recommendations which would not unduly discourage the issuance of financial forecasts and which would permit experimentation in the development of communicative formats. Accordingly, when information described as a financial forecast is issued, it should include presentation of at least the following information (when applicable):

- a. Sales or gross revenues.
- b. Gross profit.
- c. Provision for income taxes.
- d. Net income.
- e. Disposal of a segment of a business and extraordinary, unusual or infrequently occurring items.
- f. Primary and fully diluted earnings per share data for each period presented.
- g. Significant anticipated changes in financial position.

### **Accounting Principles**

.15 Financial forecasts should be prepared on a basis consistent with the generally accepted accounting principles expected to be used in the historical financial statements covering the forecast period. This fact, as well as a summary of significant accounting policies, should be disclosed in the forecast. If a forecast is included in a document which contains such a summary, disclosure can be accomplished by cross-referencing.

.16 If the financial forecast gives effect to a change in accounting principle from one used in the historical financial statements of prior periods, the change should be reported in the forecast for the period in which it is expected to be made as would be required in reporting such accounting change in historical financial statements.

### **Expressing the Results**

.17 Financial forecasts should be expressed in specific monetary amounts representing the single most probable forecasted result. The tentative nature of a financial forecast would be

emphasized if the single most probable result for key measures (e. g., sales and net income) was supplemented by ranges or probabilistic statements, and the presentation of such information is encouraged.

.18 While a range informs the user of the probabilistic nature of the forecast, expressing a financial forecast *solely* in terms of ranges could result in the user's attributing an unwarranted degree of reliability to the forecast ranges, because many users might assume (a) that a range represented the spread between the best possible result and the worst possible result or (b) that the range was based on a scientifically determined interval. Management should be in the best position to determine the single most probable result, and this burden should not be placed on outsiders. Also, single point estimates are necessary to aggregate the forecasts of an enterprise's individual operations, as well as to facilitate comparison between the forecast and later historical results.

### Assumptions

.19 Those assumptions should be disclosed which management thinks are most significant to the forecast or are key factors upon which the financial results of the enterprise depend. There ordinarily should be some indication of the basis or rationale for these assumptions. It would also be desirable for the disclosure to include an expression of the relative impact of a variation in the assumption when it would significantly affect the forecasted result.

.20 Frequently, basic assumptions that have enormous potential impact are considered to be implicit in the forecast. Examples might be conditions of peace, absence of natural disasters, etc. Such assumptions need be disclosed only when there is a reasonable possibility that the current conditions will not prevail. In such circumstances, to the extent practicable, the possible impact of a change in the assumptions should be disclosed.

.21 A financial forecast is based on assumptions representing management's judgment of the most likely circumstances and events and its most likely course of action. Assumptions are the single most important ingredient of a financial forecast. However, regardless of the amount of study or analysis, some assumptions inevitably will not materialize.

.22 There are several other factors with respect to the disclosure of assumptions which must be considered, particularly when the disclosures are external to the enterprise.

- a. By nature, a financial forecast embodies a large number of assumptions, especially for a complex enterprise. An attempt to communicate "all" assumptions is inherently not feasible.
- b. Outside users who disagree with one or more assumptions in a forecast are generally not able to adjust for the effect of these differences in assumptions on the forecast.
- c. Questions may arise after the fact as to certain assumptions which were not disclosed. Unforeseen changes in conditions may make certain assumptions, previously considered unimportant, significant.

.23 Consideration of these factors does not change the previous conclusion that significant assumptions underlying a financial forecast should be disclosed.

.24 Disclosure of certain important information may not be desirable from the standpoint of the enterprise, particularly when competition or strategies are involved. While all significant assumptions should be disclosed, they need not be presented in such a manner or in such detail as would adversely affect the competitive position of the enterprise.

.25 Assumptions should be captioned in a manner which best reflects their nature, such as "Summary of Significant Forecast Assumptions." It should be made clear that the assumptions disclosed are not an all-inclusive list of those used in the preparation of the forecast and that they were based on circumstances and conditions existing at the time the forecast was prepared. Accordingly, the summary of assumptions should be preceded by an introduction similar to the following:

This financial forecast is based on management's assumptions concerning future events and circumstances. The assumptions disclosed herein are those which management believes are significant to the forecast or are key factors upon which the financial results of the enterprise depend. Some assumptions inevitably will not materialize and unanticipated events and circumstances may occur subsequent to . . . . ., the date of this forecast. Therefore, the actual results achieved during the forecast period will vary from the forecast and the variations may be material.

.26 Identifying those assumptions which, at the time of preparation, appear to be most significant to the forecast or which are key factors upon which the financial results of the business depend requires the careful exercise of good-faith judgment by management. The disclosures should include the following:

- a. Assumptions as to which there is a reasonable possibility of the occurrence of a variation that may significantly affect the forecasted results.
- b. Assumptions about anticipated conditions that are expected to be significantly different from current conditions, which are not otherwise reasonably apparent.
- c. Other matters deemed important to the forecast or to the interpretation of the forecast.

.27 The following unrelated hypothetical examples of disclosures of assumptions are offered for general guidance:

- a. The Company is engaged in several lines of business, two of which are defense-oriented and supplied X% and Y% of the Company's sales and gross profit, respectively, in 1974, as indicated on page — of the Annual Report to Stockholders. The Company's other lines of business are diversified.

The sales forecast assumes, among other things, that revenue from the Company's federal defense contracts will continue at the current level and that non-defense sales will increase at the same rate as the anticipated increase in real GNP for 1975.

If these conditions are not met, results may be significantly affected. For example, a decline of 5% from forecasted defense-oriented sales could result in a decline of approximately 8% in net income, while a decline of 5% from forecasted non-defense sales could result in a decline of approximately 6% in net income.

- b. The Company expects its raw material costs to rise, on an overall basis, commensurate with the rate of inflation. The forecast assumes any raw material cost increases can be recovered in the form of higher prices. Labor costs have been forecasted using rates provided in the Company's union contract, which does not expire until 1976.

- c. At certain times in the year, the Company is highly dependent on short-term bank borrowing. The Company's forecast of interest expense is based on the seasonal borrowing patterns of prior years for financing inventory and receivables. The Company does not expect to incur any long-term borrowing and anticipates no major changes in the prime rate from its present level of X%.
- d. The provision for income taxes gives no effect to the possibility of a 6% decrease in the maximum corporate income tax rate, as proposed by the President in a message to Congress.
- e. Manufacture of the Company's major products depends on the availability of relatively small quantities of petroleum by-products. The Company has no guaranteed source for these materials. The forecast assumes continued availability of these raw materials.
- f. Earnings per share data have been computed following the same procedures used for historical financial statement purposes, which are in accordance with the provisions of APB Opinion No. 15. In calculations required by the "treasury stock" method, management has assumed, for such purposes, that there will be no significant changes in the price of the Company's stock.

### **Period to Be Covered**

.28 Management should consider its ability to forecast and the needs of the user in determining the period to be covered. No fixed period of time is specified herein.

.29 Although the degree of uncertainty generally increases with the time span, short-term forecasts may not be meaningful in (a) industries with a lengthy operating cycle or (b) situations where long-term results are necessary to evaluate the investment consequences involved.

### **Distinguishing From Historical Financial Statements**

.30 Financial forecasts should be presented separately (or clearly segregated) from the historical financial statements and should be clearly labeled as a "financial forecast" to preclude a

reader from confusing a forecast with the historical financial statements.

.31 Applicable historical *information*, such as prior forecast data and prior historical results, may, however, be presented with any financial forecast in parallel columns. This would facilitate comparison and provide the user with information helpful in evaluating the risks associated with a financial forecast. When such historical information is presented, it should be clearly labeled and distinguished from the forecast information.

### **UPDATING FINANCIAL FORECASTS**

.32 An updated financial forecast should be issued to reflect significant changes in assumptions, actual results, or unanticipated events and circumstances unless (a) the original forecast included a statement that it was not intended to be updated (see par. .36) or (b) issuance of historical financial statements covering the forecast period is imminent.

.33 An updated forecast should be issued if it can be done promptly. The reasons for updating should be described in a note to the updated forecast.

.34 When material changes in a forecast cannot be quantified so as to permit issuance of an updated forecast promptly, appropriate disclosure should be made. Such disclosure would include a description of the circumstances necessitating an updated forecast, and notification that the forecast should not be used for any purpose and that an updated financial forecast will be issued upon its completion.

.35 If, however, management decides that the current financial forecast should no longer be used for any purpose but it is not appropriate to issue an updated forecast, this decision and the reasons for it should be disclosed.

### **Forecasts Not Intended to Be Updated**

36. Financial forecasts may be issued on a "one-time" basis, such as in connection with a search for debt or equity financing, without any intention to issue updated forecasts. In such cases, emphasis should be given to the date of issuance of the forecast and an explicit statement should be made as to the dangers inherent in using forecasts issued some time ago. In addition,

management's intention not to update the forecast should be specifically disclosed.

## **ACCOUNTING STANDARDS DIVISION**

### **Accounting Standards Executive Committee**

**STANLEY J. SCOTT, Chairman**

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### **Accounting Standards Task Force on Financial Forecasts**

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Director, Accounting Standards**

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**➤➤➤ ➔ The next page is 18,031. ➔ ➤➤➤**



## Section 10,090

# Statement of Position 75-5 Accounting Practices in the Broadcasting Industry

[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

December 29, 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 in the Broadcasting Industry. It was prepared on behalf of the Division by the Accounting Standards Task Force on Entertainment Companies for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate. The Division suggests that the recommendations contained herein be required to be applied in financial statements for fiscal years beginning on or after January 1, 1976 (or beginning in late December, 1975 for enterprises having fiscal years of 52 or 53 weeks).

The Statement discusses three areas of interest to broadcasters: television film license agreements, barter transactions and intangible assets.

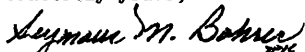
The Statement concludes that assets and liabilities should be recorded for television film license agreements with respect to films available for telecasting. Guidelines are provided for the classification of these assets and liabilities. The film rights recorded as an asset should, it holds, be amortized using an accelerated method over the number of future showings estimated by management when the first showing, as is usually the case, is more valuable to a station than reruns. The Statement also takes the position that the provisions of APB Opinion No. 21 are applicable to television film license agreements.

Barter transactions involve the exchange of unsold advertising time for products or services. The Statement concludes that all barter transactions should be recorded by estimating the fair value of the product or service received, in accordance with the provisions of APB Opinion No. 29.

Finally, the Statement provides guidance with respect to the application of APB Opinion No. 17 to intangibles in the broadcasting industry, pending reconsideration by the FASB of the broad area of business combinations and purchased intangibles.

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,



SEYMOUR M. BOHRER

Chairman

Accounting Standards Task Force  
on Entertainment Companies

cc: Securities and Exchange Commission

➡ The next page is 18,033. ←



**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 IN THE  
BROADCASTING INDUSTRY****GENERAL BACKGROUND**

.01 The Federal Communications Commission (FCC) is responsible for the general regulation of television and radio broadcasters. Under current regulations, stations are licensed for three year periods to use assigned frequencies in specific locations. These frequencies are limited and are part of the public domain. The FCC has the authority to consider quality of programming, financial ability of station ownership, amounts of advertising, attention to community service and other factors in determining whether a license should be granted or renewed. The FCC does not, however, regulate rates. The National Association of Broadcasters has set forth guidelines with respect to the amount of advertising time which may be sold.

.02 Broadcasters derive revenue from national, regional and local advertisers. In addition, if a station is affiliated with a network it receives compensation for the network programming that it carries, based on a formula designed to compensate the station for commercial time sold on a network basis and included in network programming. Rates charged by stations vary considerably from market to market and within markets. The prices charged for advertising time are generally based upon the size and demographics of the estimated audience reached, which in turn depends on the size of the market and on the audience's acceptance of the station's programming. Station audiences are measured during rating periods to determine the size and demographic composition of the audiences reached. A station's selling prices (rate cards) are set by program or time periods, to reflect

current audience ratings. Rate cards are revised periodically to reflect subsequent audience ratings and/or changes in economic conditions. While there is not always a direct relationship between revenues and expenses for a specific program, a station must maintain audience acceptance of its programming over a period of time or suffer a reduction in its rate schedule as compared to other stations in the market.

.03 Revenues are recognized when the station broadcasts the advertising the sponsor has contracted for. The networks report certain revenue information to their affiliates weekly and distribute that revenue monthly.

.04 Broadcasters may barter unsold advertising time for products or services. Such transactions permit the station to obtain something of value for time which might otherwise remain unsold. The station benefits, if bartering does not interfere with its cash sales, by exchanging otherwise unsold time for programs, fixed assets, merchandise, other media advertising privileges, travel and hotel arrangements, entertainment, and other services and products received from advertisers or agencies acting on their behalf.

.05 A major expense of a television station is its programming costs. These costs are substantially higher for an independent station than for a network affiliate because the affiliate does not incur programming costs for network showings and records only its network advertising revenue. The network recovers its programming costs through the sale of national advertising. Television stations include, however, many hours of non-network programming in their schedules. These programs, other than local news and interview shows and the like, are usually on video tape or film. They are generally contracted for under television license agreements and represent the largest element of programming expense for both network affiliated and independent stations.

.06 A broadcaster's principal intangible assets are its network affiliation agreement(s) and FCC license. Without an FCC license, it is impossible to earn revenue no matter how large the investment in equipment, people and programs. A network affiliated station is generally more valuable than an independent station in the same market because of network supplied programming and revenues. Network programming generally improves the audience levels during network and non-network programming periods. The improvement in audience levels

tends to increase the rates and resultant revenue that a station receives from its national and local sales to advertisers.

.07 The Division has noted that there are variations in practice with respect to accounting by broadcasters, including networks, for certain transactions. This Statement of Position has been issued to narrow the range of acceptable alternative practices in the following areas:

- Accounting for television film rights and related license fees.
- Accounting for barter transactions.
- Accounting for network affiliation agreements and FCC licenses.

## **TELEVISION FILM LICENSE AGREEMENTS**

### **Industry Practice**

.08 Broadcast rights for feature length motion pictures, series produced for television, cartoons and other films are generally sold by producers or distributors to broadcasters for television exhibition under a contract which typically includes several films (a package) and permits one or more exhibitions of each film during specified license periods. (Certain licenses, however, permit unlimited showings during a specified period of time.) Fees stipulated in the agreement are usually payable in installments over a period of time which is generally shorter than the period of the licensing contract. The license expires after the last allowed telecast or at the end of the specified period even if the licensee telecasts a film less than the allowed number of times.

.09 Accounting practices with respect to film rights and related fees vary. The most common alternatives are summarized below:

1. The unpaid fees stipulated in the agreement are considered to be commitments, not liabilities, and neither the film rights nor the related fees are recorded in the balance sheet. Disclosure practices of companies following this alternative are not consistent.
2. Assets and liabilities are recorded for all television film license agreements. The liabilities are classified as current or noncurrent on the basis of the payment

terms specified in the agreement but the assets are classified in different ways:

- (a) All film rights reported as current assets.
  - (b) All film rights reported as noncurrent assets.
  - (c) Film rights segregated between current and noncurrent based on—
    - (i) Availability for telecasting, or
    - (ii) Estimated usage within one year.
3. Assets and liabilities are recorded only with respect to those films which are currently available for telecasting. These assets and liabilities are classified in the balance sheet under one of the alternatives described in 2 above.

.10 Those broadcasters who record film rights as assets amortize those assets using one—or a combination—of the following methods:

- 1. Straight-line based on the period of the agreement.
- 2. Straight-line based on the number of showings specified in the agreement.
- 3. Straight-line based on the number of showings estimated by management.
- 4. Accelerated by assigning higher values to earlier showings, either based on the number of showings specified in the agreement or based on the number of showings estimated by management.
- 5. Accelerated by using the sum-of-the-years' digits, declining-balance, or variations of those methods.
- 6. Higher of (a) straight-line based on either the specified or estimated number of showings, or (b) straight-line over the contract period commencing with date of first showing.

.11 The provisions of APB Opinion No. 21, *Interest on Receivables and Payables*, are also not applied consistently to the receivables and payables arising from television film license agreements. Most film licensors impute interest on the receivable arising from the agreement. As a general rule, licensees do not impute interest on the payable. The Opinion is 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. . . ." The Opinion is not intended to apply to certain exempted transactions, but none of these exemptions is applicable to television film license agreements unless the receivables and payables arising from those agreements are "due in customary trade terms not exceeding approximately one year." In addition, those few broadcaster-licensees who do impute interest follow different methods:

1. Interest is imputed and expensed on all license agreements.
2. Interest is imputed and expensed only on those license agreements for films which are currently available for telecasting.
3. Interest is imputed on all license agreements but capitalized as additional costs of film rights.

.12 The practices which exist with respect to the recording of assets and liabilities under television film license agreements, the classification of any recorded assets and liabilities, the amortization of film license costs, and the application of APB Opinion No. 21, provide a broadcaster with the ability to select from a large number of combinations of alternative methods. The Division's conclusions with respect to these alternatives are summarized in the next section.

### **The Division's Conclusions**

.13 The AICPA Industry Accounting Guide, *Accounting for Motion Picture Films*, specifies that a licensor should record a receivable and recognize income with respect to film license agreements at the commencement of the license period if all of the following conditions have been met:

1. The sales price for each film is known.
2. The cost of each film is known or reasonably determinable.
3. Collectibility of the full license fee is reasonably assured.
4. The film has been accepted by the licensee in accordance with the conditions of the license agreement.
5. The film is available; i. e., the right is deliverable by the licensor and exercisable by the licensee.

.14 The Division concludes that broadcasters' accounting should parallel the accounting by the licensor (although condition 3 above would not, of course, apply) and, accordingly, assets and liabilities should now be recorded in the accounts for the rights acquired and the obligations incurred under license agreements for those films available for telecasting.

.15 The assets should be segregated between current and noncurrent based on estimated usage within one year, and the liability should be segregated between current and noncurrent based on the payment terms specified in the license agreement. This is in accordance with generally accepted accounting principles as set forth in Accounting Research Bulletin No. 43, Chapter 3, Section A, and is also the predominant practice in the industry. The commitment for license agreements executed but not recorded because they are not currently available for telecasting should be disclosed in the notes to the financial statements.

.16 The Division believes that film rights should now be amortized based on the number of future showings estimated by management. This applies equally to licenses providing for limited showings and those with unlimited showings. Feature films should be amortized on an individual film basis. Film series and other syndicated products should be amortized on a series basis. Amortization of feature films on a film package basis may be appropriate if it approximates the amortization that would have been provided on a film-by-film basis. Licenses providing for unlimited showings of cartoons and films with similar characteristics may be amortized over the period of the agreement since this type of film may, in practice, actually be shown on an almost unlimited basis. Costs should be allocated to individual films within a film package on the basis of the relative value of each to the broadcaster.

.17 The Division has concluded that an accelerated method of amortization which takes into consideration the station's programming pattern is now required when the first showing, as is usually the case, is more valuable to a station than reruns. Accordingly, the straight-line method of amortization is only acceptable in those instances where each telecast is expected to generate similar revenues.

.18 Film costs should be carried in the balance sheet at the lower of unamortized cost or estimated net realizable value on a



film-by-film, series, or package basis, as appropriate. Unamortized cost would normally not exceed estimated net realizable value; however, in those situations when management's expectations of the programming usefulness of a film, series or package are revised downward, it may be necessary to charge expense to reduce unamortized cost to estimated net realizable value. A write-down from unamortized cost to a lower estimated net realizable value establishes a new cost basis. Similar losses expected to arise from unrecorded television film license agreements should also be provided for by a charge to expense.

.19 Finally, the Division has also concluded that the provisions of APB Opinion No. 21 are applicable to television film license agreements and, accordingly, interest should now be imputed on the recorded liabilities and amortized as interest expense in conformity with paragraph 15 of the Opinion.

## **BARTER TRANSACTIONS**

### **Industry Practice**

.20 Present practices for recording barter revenue vary considerably, as indicated below:

1. Revenue and expense are not recognized for financial reporting purposes. (Memorandum records are usually maintained for FCC reporting purposes.)
2. Revenue is recorded when commercials are broadcast.
3. Revenue is recorded when merchandise or services are received.

.21 There is also a lack of uniformity in the methods of valuing the two sides of the transaction:

1. Fair value of merchandise or services received.
2. Retail value of merchandise or services received.
3. Value of commercial spots at standard ("rate card") rates.
4. Value of commercial spots at a discounted rate.

### **The Division's Conclusions**

.22 The Division has concluded that all barter transactions should now be recorded by estimating the fair value of the product or service received, in accordance with the provisions of paragraph 25 of APB Opinion No. 29. Barter revenue should

now be recorded when commercials are broadcast, and merchandise or services received should be recorded when received or utilized. If merchandise or services are received prior to the broadcast of the commercial, the deferred revenue should be recorded. Likewise, if the commercial is broadcast first, a receivable should be recorded.

.23 Television film license agreements, game shows and other programming, exclusive of network programming, obtained in exchange for a specified number of commercials should be valued at the fair value of the programming received.

.24 Barter revenue should be disclosed in the financial statements when it is material, in accordance with paragraph 28 of APB Opinion No. 29.

## **INTANGIBLE ASSETS**

### **Industry Practice**

.25 A network affiliation agreement and an FCC license are intangible assets frequently transferred to the buyer upon the purchase of a broadcasting station. An additional intangible asset arising upon the acquisition by purchase of a broadcasting station may be an excess of cost over the fair value of net identifiable tangible and intangible assets acquired (goodwill).

.26 Present practices with regard to the balance sheet presentation of these items and their amortization vary. Amounts allocated to network affiliation agreements, FCC licenses and goodwill are frequently presented by some companies as one amount and identified as "Intangibles," "Excess of Cost Over Underlying Net Assets Acquired," or other all-encompassing descriptions which frequently include the word "Goodwill." Other companies, however, segregate their intangible assets into components on the face of the balance sheet or in the notes thereto. Companies amortize these intangible assets in conformity with the requirements of APB Opinion No. 17 and generally use the maximum 40-year period for assets acquired after October 31, 1970, the effective date of APB Opinion No. 17. Intangible assets arising prior thereto are usually not amortized on the basis that there has been no diminution in value.

.27 The Institute of Broadcasting Financial Management, Inc., the financial management association of the broadcasting industry, and the National Association of Broadcasters have established a joint committee which has submitted a position

paper to the Financial Accounting Standards Board on accounting for intangibles in the broadcasting industry.

.28 The joint committee believes that broadcasting intangibles have several characteristics which are shared with few, if any, other types of intangible assets, for the following reasons. First, broadcasting licenses and network affiliation contracts are identifiable assets which are granted under contractual terms having a virtually unlimited duration. Secondly, they have historically retained their original value and generally increased in value over a period of time. Third, the intangibles are marketable assets, inasmuch as they can be and frequently are sold, thus their value when compared to the sales of similar properties can be reasonably estimated.

.29 The joint committee's position paper requests that Accounting Principles Board Opinion No. 17 be modified by the Financial Accounting Standards Board, to provide that (1) the amortization or write-down of broadcasting licenses and network affiliation contracts be required only if their estimated value and future benefits are lower than their carrying value and (2) that the amortization or write-down of these assets below their residual value not be required. The joint committee acknowledges that a diminution in the value of these intangible assets should be recognized either through systematic amortization or write-offs as is warranted by the circumstances.

### **The Division's Conclusions**

.30 The Division believes that the provisions of APB Opinion No. 17 apply to intangibles in the broadcasting industry as well as in other industries and should be followed, absent any action by the Financial Accounting Standards Board.

.31 APB Opinion No. 16, paragraph 68, requires that the cost of an acquisition be allocated to each individual asset acquired on the basis of its fair value. The individual assets are comprised of the tangible and identifiable intangible assets acquired. APB Opinion No. 17, paragraph 26, elaborates on this with the statement that "Cost should be assigned to all specifically identifiable assets; costs of identifiable assets should not be included in goodwill." Therefore, separate costs should be assigned to network affiliation agreements and any other identifiable intangible assets.

.32 The Division has concluded that when a network affiliation is terminated and not immediately replaced or under agreement to be replaced, the unamortized balance of the amount originally allocated to the network affiliation should be charged to expense. If a network affiliation is terminated and immediately replaced or under agreement to be replaced, and the fair value of the new network affiliation equals or exceeds the unamortized cost of the terminated affiliation, no gain should be recognized. However, a loss should be recognized to the extent that the unamortized cost of the terminated affiliation exceeds the fair value of the new affiliation.

.33 The amortization policy of the broadcaster should not be changed solely because there has been a change in the network with which the station is affiliated.

**ACCOUNTING STANDARDS TASK FORCE  
ON ENTERTAINMENT COMPANIES**

Seymour M. Bohrer,  
Chairman

Charles N. Johnson

Harold D. Kassel

Roger G. Marcellin

Alan May, Jr.

Robert G. McLendon

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Thomas P. Kelley,

Director,

Accounting Standards

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**Section 10,100**

# **Statement of Position 75-6**

## **Questions Concerning Profit Recognition on Sales of Real Estate**

**[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

December 29, 1975

Marshall S. Armstrong, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

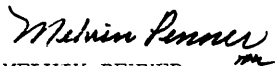
Dear Mr. Armstrong:

The accompanying Statement of Position has been prepared by the Accounting Standards Task Force on Real Estate Accounting to clarify the AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate.

Numerous questions have arisen in practice with respect to the application of the general principles and specific conclusions set forth in the Guide. Questions as to the applicability of the Guide to specific transactions and to companies other than real estate companies have also been raised. The Task Force has identified certain key questions and has recommended appropriate responses to them in this Statement of Position.

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,



MELVIN PENNER  
Chairman  
Accounting Standards Task Force  
on Real Estate Accounting

cc: Securities and Exchange Commission

➡ The next page is 18,083. ⬅



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.

**QUESTIONS CONCERNING PROFIT RECOGNITION  
ON SALES OF REAL ESTATE**

**BUYER'S INVESTMENT IN PURCHASED PROPERTY**

**Funds Provided (Loaned) by Seller**

*Question:*

.01 With respect to paragraph 22 of the Guide,\* what is the effect on the test of the adequacy of the down payment in a sale of real estate if the seller has made or will be making loans to the buyer builder/developer for acquisition, construction or development purposes? What is the effect of the existence of a permanent loan commitment by an independent third party?

*Answer:*

.02 Under paragraph 22, *any* funds that have been loaned or will be loaned, directly or indirectly, to the buyer by the seller must first be deducted from the down payment in determining whether the down payment test has been met. Paragraph 22 does not require that the funds loaned by the seller be specifically identified with the funds comprising the down payment. As an

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\* The paragraph and exhibit references are to appropriate sections of the AICPA Industry Accounting Guide, *Profit Recognition on Sales of Real Estate*.

example, if “A” sells unimproved land to “B” for \$100,000, receives a down payment of \$50,000 in cash, and plans to loan “B” \$35,000 at some future date for installation of water and sewer lines, the down payment test has not been met. ( $\$50,000 - \$35,000 = \$15,000 \div \$100,000 = 15\%$ ; fails test as at least 20% is required.)

.03 Funds provided directly or indirectly by the seller include loan guarantees, collateral provided by the seller, and any other situation where the seller is subject to loss as a result of funds loaned to the buyer.

.04 Existence of a permanent loan commitment by an independent third party for replacement of the construction or development loan made by the seller does not eliminate the need to deduct the seller’s loan from the down payment under paragraph 22. The Guide did not intend that consideration be given to such commitments and construction or development loans by the seller to the buyer must be deducted from the down payment whether or not a permanent loan commitment exists.

### **Acceptable Letters of Credit**

#### *Question:*

.05 Paragraph 22 of the Guide requires that a buyer’s down payment be composed of cash or notes supported by irrevocable letters of credit from an established lending institution. What constitutes an “established lending institution?” If the letters of credit are obtained subsequent to the period in which the transaction takes place but prior to the issuance of the financial statements, is it appropriate to include them for purposes of determining compliance with the down payment criteria in the earlier period?

#### *Answer:*

.06 An “established lending institution” refers to institutions, usually commercial banks, that issue letters of credit in the normal course of business.

.07 Buyer’s notes, unless and until supported by irrevocable letters of credit covering the period of the notes, do not constitute cash equivalency (see paragraph 15) in a real estate transaction. Accordingly, the down payment criteria are not met for accounting purposes until the period in which letters of credit are obtained.



**Cumulative Application of Tests when  
Recognition of Sale is Delayed**

*Question:*

.08 Paragraph 27 of the Guide states that the “tests of adequacy of a buyer’s initial and continuing investment . . . should be applied cumulatively—at the closing date and annually afterwards.” What date should be used for the purpose of these tests when the transaction is not recorded as a sale for accounting purposes on the closing date and the proceeds are accounted for as a deposit?

*Answer:*

.09 The Guide indicates that under certain conditions the effective date of the sale for accounting purposes is required to be deferred (see paragraphs 9, 34, 35, 42, 45 and 54). When a transaction is recorded under the deposit method, the date from which the cumulative test would begin to apply would be delayed until the sale is recorded for accounting purposes.

**Applicability of the Alternative  
115% Test for Down Payment**

*Question:*

.10 Does the alternative 115% test for down payment under paragraph 20 of the Guide apply if (a) the seller takes a receivable, collateralized by a first mortgage on the property sold, for the entire difference between the sales value and the down payment, or (b) if the buyer assumes, or takes the property subject to, a primary loan that is not a newly placed permanent loan for a portion of the difference between sales value and the down payment?

*Answer:*

.11 No. The 115% test for down payment in paragraph 20 does not apply if a newly placed permanent loan or firm loan commitment from an independent lender is not involved.

**Down Payment Requirements on Single Family  
Residential Housing**

*Question:*

.12 Footnote (b) to Exhibit A (minimum down payment requirement) calls for a higher down payment on sales of single

family residential property if collectibility of the remaining portion of the sales price cannot be supported by reliable evidence of collection experience. Do the provisions of footnote (b) apply when independent first mortgage financing is utilized?

*Answer:*

.13 No. The provisions of footnote (b) are applicable when independent first mortgage financing is not utilized and the seller takes a receivable from the buyer for the difference between the sales value and the down payment. When independent first mortgage financing is utilized, the minimum down payment on sales of single family residential property should be determined in accordance with paragraph 20 of the Guide.

## **SELLER'S CONTINUED INVOLVEMENT WITH PROPERTY SOLD**

### **Time of Sale Considerations**

*Question:*

.14 Are paragraphs 47-48 and 60 of the Guide in conflict with the closing requirements in paragraph 14 of the Guide? Paragraphs 47-48 and 60 permit income recognition during a development or construction phase assuming all other conditions of the Guide are met. On the other hand, paragraph 14 includes as a prerequisite to income recognition the criterion that “. . . all conditions precedent to closing have been performed.” One major condition precedent to closing on such properties as buildings, condominiums, etc., is that the structure be ready or certified for occupancy. Which of these paragraphs prevails? If an exception to paragraph 14 is intended with respect to completion, then are exceptions intended with respect to any other requirements of paragraph 14?

*Answer:*

.15 Because of the length of the construction period of office buildings, condominiums (especially high rise), shopping centers and similar structures (excluding single family homes), the Guide was written to permit income recognition during the process of construction even though the fact of completion is usually a “condition precedent,” and thus this exception to paragraph 14 is an exception to this condition only.

## Calculation of Safety Factor

### Question:

.16 In applying Exhibit C, paragraph 55 of the Guide states "that estimated rent receipts should be reduced by a safety factor of  $33\frac{1}{3}\%$  unless signed lease agreements have been obtained to support a projection higher than the rental level thus computed." Should the  $33\frac{1}{3}\%$  reduction be applied to the *total* estimated future rent receipts (including the amount resulting from signed lease agreements) or only to the estimated future rent receipts which are not yet subject to signed lease agreements?

### Answer:

.17 The  $33\frac{1}{3}\%$  reduction should be applied to the *total* estimated future rent receipts for each period unless the amount so computed is less than the actual amount of rent receipts resulting from signed lease agreements. In this event, the actual amount would be substituted for the computed amount.

.18 As an example, "A" sells an office building under development to "B" together with an agreement to support operations of property for a period of three years. The projected annual rent roll is \$1,000,000, of which \$350,000 is supported by signed lease agreements. The *projected* rental income for the first year of operation of the office building is \$600,000, the second year \$750,000 and the third year \$1,000,000. *At the time of sale*, the amounts includible in the Exhibit C calculation would be computed as follows:

Year	Projected Rental Income	Safety Factor ( $33\frac{1}{3}\%$ )	Adjusted Projected Rental Income
1	\$ 600,000	\$200,000	\$400,000
2	750,000	250,000	500,000
3	1,000,000	333,333	666,667

.19 In the example, if at the time of sale there were signed lease agreements in the amount of \$450,000, then the \$450,000 would be used in year 1 since it is greater than the adjusted projected rental income. The adjusted projected rental income for years 2 and 3 would remain \$500,000 and \$666,667, respectively.

**Sales of Condominiums***Question:*

.20 Paragraph 60 of the Guide with respect to sales of condominium units states that "profit should not be recognized . . . unless construction is beyond a preliminary stage, the buyer is committed to the extent of being unable to require a refund, sufficient units have already been sold to assure that the property will not revert to rental property, and aggregate sales proceeds can be estimated reasonably." What do each of the above criteria for profit recognition mean?

*Answer:**Construction Is Beyond a Preliminary Stage*

.21 Actual construction of buildings usually must be preceded by engineering and design work, execution of construction contracts, site clearance and preparation, excavation and completion of the building foundation. Ordinarily, if any one of these required phases is incomplete, the work is not beyond a preliminary stage.

*The Buyer Is Committed to the Extent of Being Unable to Require a Refund*

.22 The buyer cannot have the right under the terms of the agreement or by law to receive a refund, except for nondelivery of the unit. Examples where a sales contract may not be binding and therefore voidable may include but are not limited to the following:

- Certain states require a minimum status of completion of the project.
- Certain states require that a "Declaration of Condominium" be filed. (In some states, however, the filing of the declaration is a routine matter and the lack of such filing may not make the sales contract voidable.)
- Some sales contracts include a provision that permanent financing at an acceptable cost must be available to the buyer at the time of closing.
- Certain condominium units must be registered with either the Office of Interstate Land Sales Registration of the Department of Housing and Urban Development or the Securities and Exchange Commission.

*Sufficient Units Have Already Been Sold to Assure that the  
Property Will Not Revert to Rental Property*

.23 In determining whether or not this condition has been met, the following should be considered:

- Economic conditions.
- Developer's history.
- State laws may require that a specified percent of units be sold.
- Sales contract may provide buyer with right of rescission until a specified percent of units are sold.
- Seller may retain right to convert to rental basis.
- Construction loans may require that a specified percent of units be sold before the lender will release any units.
- End loan financing commitments may provide that a specified percent of units be sold before closing of any sale.

.24 The Guide intended to preclude recognition of profit on sales of condominium units which can later be rescinded because the *entire* property reverts to a rental project. Technically, this provision of the Guide may be satisfied when the number of units sold meets the requirements of the state law (or relevant jurisdiction), the condominium contract and the financing agreement, so that such sales are not legally voidable either by the buyer or the seller. Nevertheless, there is a presumption that at least 50% of the individual units should be sold before any profit is recognized on the percentage of completion method. The reason for this presumption is that profit attributed to units sold may not be subject to reliable estimates until a substantial number of units are sold, because of uncertainties concerning either the ultimate number and sales value of units to be sold (see below) or the costs to be incurred.

*Aggregate Sales Proceeds Can Be Reasonably Estimated*

.25 Consideration should be given to sales volume, trends of unit prices, developer's experience, geographical location and environmental factors. Sometimes certain units in a condominium project are difficult to sell, indicating that the pricing structure may not reflect realizable sales value. For example, certain units may have been designed in a manner that does not reflect changes in market demand, or certain units may not be as desirable as others because of location or aesthetic factors. In these cases, consideration should be given to the possibility

that some of the remaining units may not be sold or may have to be sold at substantially reduced prices.

## **APPLICABILITY OF THE GUIDE**

### **Applicability to Companies Other Than Real Estate Companies**

*Question:*

.26 Paragraph 3 states that the Guide was prepared to appraise accounting practices in the real estate industry. Are the principles in the Guide applicable to manufacturing, distribution and other companies which are not real estate companies?

*Answer:*

.27 Yes. The Guide was meant to apply to all sales of real estate, except retail lot sales covered by the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales*, without regard to the nature of the seller's business.

### **Sale of Corporate Stock**

*Question:*

.28 The Guide primarily covers the timing of profit recognition on real estate sales. Does the Guide apply to the sale of corporate stock of a company with substantial real estate?

*Answer:*

.29 If the sale is in economic substance a sale of real estate, provisions of the Guide would apply.

### **Sale of Partnership Interests**

*Question:*

.30 The Guide contains provisions for the timing of profit recognition if a person sells to a limited partnership in which the seller is the general partner. Is the Guide applicable if a person forms a partnership, arranges for the partnership to acquire the property directly from third parties, and sells a portion of his interest in the partnership to persons who then become limited partners?

*Answer:*

.31 The Guide is applicable. In particular see paragraphs 57 to 59 of the Guide with respect to partial sales.

### **Sale of an Option**

*Question:*

.32 The Guide primarily covers the timing of profit recognition on real estate sales. Does the Guide apply to the sale of options to purchase real estate?

*Answer:*

.33 Yes. Sale of such an option is a sale of an interest in real estate and, accordingly, the principles in the Guide apply.

.34 For purposes of evaluating the buyer's commitment when an option is sold by an option holder, the initial and continuing investment by the buyer of the option (which would exclude amounts which are subject to refund by the seller) should be related to the total of the exercise price of the option and the sales price of the option. For example, if the option is sold for \$150,000, (\$50,000 cash and a \$100,000 note) and the exercise price is \$500,000, the sales value against which the buyer's down payment and continuing investment is measured is \$650,000. If the buyer's investment is inadequate, income may be recorded on the cost recovery method to the extent non-refundable cash proceeds exceed the seller's cost of the option.

.35 Proceeds from the issuance of a real estate option by a property owner should be accounted for as a deposit as set forth under paragraph 35 of the Guide. It is not appropriate to recognize income before the option either expires or is exercised because the sale of the option cannot be evaluated independently from the sale of the real estate to which the option relates. If the option is exercised, cash proceeds from the issuance of the option should be accounted for as a down payment and included in sales value.

#### **ACCOUNTING STANDARDS TASK FORCE ON REAL ESTATE ACCOUNTING**

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Thomas P. Kelley,  
Director,  
Accounting Standards

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**Section 10,110*****Statement of Position 76-1  
Accounting Practices in the Record and  
Music Industry*****[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

August 25, 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 in the Record and Music Industry. It was prepared on behalf of the Division by the Accounting Standards Task Force on Entertainment Companies for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement discusses several areas where different accounting practices exist in the record and music industry: revenue recognition, inventory valuation, compensation of artists, costs of record masters, licensor income and licensee cost, and intangible assets acquired in a business combination.

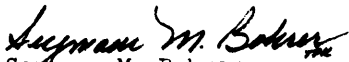
The Statement's major recommendations are briefly summarized below:

- Manufacturers and distributors in the record and music industry must be able to make a reasonable estimate of returns in order to account for shipments to customers as sales.
- The valuation of inventories in this industry should be similar to that of any other manufacturing concern and thus these inventories, including returned records, should be carried at the lower of cost or market.

- When the past performance of an artist provides a reasonable basis for estimating that advances to that artist and the cost of a record master for that artist will be recoverable, such amounts should be recorded as assets.
- In most cases, licensors should record minimum guarantees as deferred income to be amortized ratably over the performance period. However, when a license agreement is, in substance, an outright sale it should be accounted for as such. Licensees should record minimum guarantees as deferred charges to be expensed in accordance with the terms of the agreement.

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,



Seymour M. Bohrer  
Chairman

Accounting Standards Task Force  
on Entertainment Companies

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 IN THE  
RECORD AND MUSIC INDUSTRY****GENERAL BACKGROUND****Record Manufacturing****General Description**

.01 The record industry consists of numerous entities, from small operations to substantial divisions of large companies. It has certain unique characteristics. First, success in it depends to a large extent on acceptance by the public of the creative efforts of third-party composers and performers. Since such acceptance is frequently of very short duration, there is a need for prompt saturation of the marketplace to maximize revenues. (Classical and other music which has achieved sustained public acceptance are exceptions to this general rule.) Second, a relatively high portion of the manufacturer's costs consists of royalties or fees which are generally, but not always, based on net sales.

.02 A record manufacturer normally enters into a contractual arrangement (a) with the artist (performer) and possibly with a producer to record a given number of selections over a specified period of time, or (b) with a production company to deliver finished record masters of one or more artists. The phonograph discs and tapes (hereinafter referred to collectively as "records") are then manufactured and shipped for ultimate sale to the customer. The manufacturer may own or be affiliated with the pressing plant, the tape duplicator, the distributor and the retailer, or with some or none of these.

.03 The manufacturer will usually grant licenses for the sale or distribution of its products to record clubs and other direct mail operations and, for sales throughout the world, to one or more companies active in the industry in foreign countries. Again, the manufacturer may own or be affiliated with all, some or none of the licensees.

### **The Record Master**

.04 A performance is initially recorded on magnetic tape. Usually, each musical instrument and voice is recorded separately and then re-recorded to emphasize or deemphasize each sound in the final product. Such a process, called mixing, is performed by an expert sound engineer to produce a master tape, which is the "record master." The record master, in turn, is used to produce an acetate disc which is subsequently coated with metal and used to produce the molds or stampers used in commercial record production. In addition, the record master is used to make other tapes from which commercial tape cartridges, cassettes and reels may be produced.

.05 The costs of producing a record master include (1) cost of the musical talent (musicians, vocal background and arranging), (2) cost of the technical talent for engineering, directing and mixing, (3) costs for the use of the equipment to record and produce the master, and (4) studio facility charges.

### **Marketing**

.06 Marketing in the record and music industry currently includes the following levels of distribution:

- Manufacturers, as discussed above, contract with artists for the recording of selections, arrange and finance the actual recording and provide for the pressing of records and duplication of tapes or sheet music. Manufacturers generally sell to distributors, wholesale merchandisers and record clubs.
- Distributors usually sell the products of a limited number of manufacturers to wholesale merchandisers, record stores and other retail outlets.
- Wholesale merchandisers, sometimes called subdistributors or rack jobbers, function as service agencies for the music departments of chain stores and other retail outlets by supervising individual store in-

ventories, selecting titles and labels, determining quantities to be ordered, and sometimes developing advertising and promotional programs. Wholesale merchandisers usually sell the products of a variety of manufacturers and the services they provide are not normally offered by the distributor.

- Retail outlets purchase from the aforementioned suppliers and sell directly to the ultimate customer. Retail outlets include record stores, the music departments of chain and discount stores, and record clubs.
- Record clubs came into existence in the 1950's and serve as a direct line from the record manufacturer to the ultimate customer. Record clubs, including those operated by a manufacturer, commonly distribute the records of more than one manufacturer and normally offer a number of "free" records (records given free of charge or at a nominal price) as an inducement to join, subject to the new member's agreeing to purchase a certain number of records at or near retail list prices.
- Compilation records are normally manufactured from masters embodying recordings of one or more artists by one or more record manufacturers. They include more than the usual number of selections per record, are sold at prices below those charged for the original records, and are generally offered through television and radio advertising. The customer may purchase the record through the mail or directly from a designated retail outlet.

### **Recording Artist Contracts**

.07 As stated previously, a record manufacturer employs artists under personal service contracts. The major portion of artist compensation consists of a participation (measured by sales and license fee income and commonly referred to as a "royalty") and/or a non-refundable advance against royalties based upon contractual terms negotiated between the parties. The artist may agree to bear a portion or all of the costs of the record master and the manufacturer may then recoup that amount from artist royalties otherwise payable. The extent of such arrangements depends on the relative bargaining strength of each party. However, such advances and costs are generally not recoupable from the artist if royalties do not cover them.

.08 Generally, in connection with recordings made in the United States, payments are also made to various union funds under contractual arrangements which measure the obligation on the basis of sales activity. Such payments are usually not made with respect to recordings of foreign artists made in studios outside the United States.

## **Music Publishing**

### **General Description**

.09 The music itself, as opposed to a given recording, is normally controlled by a music publisher. Publishers are sometimes controlled by a record manufacturer, but in many instances publishers are either affiliates of the artist/composer or independent.

.10 The publisher normally obtains the rights to music from composers with the objective of exploiting the music for its maximum revenue. At one time, most music publishers were small, independent entities. Lately, however, there have been two trends: one toward merger with and ownership by record manufacturers, the other toward ownership by composers, who in many cases are recording artists as well.

.11 The publisher's two prime sources of revenue are royalties from record companies and royalties from public performances for profit. Other sources include revenue from the use of music in motion pictures and from the sale of sheet music.

### **Royalties**

.12 Copyright royalties to publishers are based on the U. S. Copyright Law, but the requirements of the law are normally modified by licenses issued by the publishers. By statute, royalties to publishers are due monthly at \$.02 per selection based on quantities manufactured, whereas licenses often provide for quarterly accountings at stipulated rates (which are sometimes less than \$.02) based on quantities sold. Substantial changes in the Copyright Law have been suggested and a new Act has been introduced in the last several sessions of Congress which may, if enacted, materially affect royalties. If copyrights have not been obtained or have expired, the music is in the public domain and no royalties are payable.

.13 Music publishers are normally affiliated with a collection society for collection of public performance revenue, either

ASCAP (American Society of Composers, Authors and Publishers) or BMI (Broadcast Music, Inc.). These societies collect from television and radio stations, the primary source of public performance revenue, as well as from other sources, such as live performances. Stations may supply these societies with broadcasting logs and may be monitored on a test basis. By formula and allocation, the societies determine revenue for each selection and normally pay both publishers and composers their shares directly.

.14 Music publishers in most instances have another organization act as their agent for licensing record companies and other users, collecting royalties and verifying the accuracy of the royalties paid. Publishers may sell their own sheet music or may license others to do so for a royalty.

.15 Foreign income arises from the same sources (broadcasting, live performances, sheet music, etc.). However, U. S. publishers normally grant foreign publishers exclusive rights in specific territories for varying percentages of the revenue earned in the territory.

.16 The music publishers, in turn, normally pay composers a share of the royalty receipts (excluding performance income which is usually paid directly by the collection society) and a flat rate per unit in the case of sheet music.

## **REVENUE RECOGNITION**

### **Industry Practice**

.17 The timing of revenue recognition and the determination of the amount of revenue to be reported for a given period of time can be an accounting problem because of the right of return that normally accompanies sales in the record and music industry.<sup>1</sup> These return rights can vary from unlimited to a percentage of sales, or may be in the form of exchange privileges which permit the customer to receive other records for those returned. Regardless of the form of arrangement between supplier and customer, sales are generally made with the right of return or exchange, subject to time limits that the manufacturer may establish, such as when the specific record is deleted from its catalog. These return or exchange practices have been established by manufacturers to induce customers to

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<sup>1</sup> Although the discussion which follows deals solely with records, similar practices and problems are found in the printed music industry; see paragraphs .52 and .53.

carry larger inventories than they might otherwise maintain in an industry subject to volatile swings in consumer preferences. In addition, when a manufacturer changes a distributor, it is customary to permit the former distributor to return all of the manufacturer's records for credit.

.18 It is the predominant practice in the industry to record sales when inventory is shipped and where the customer is obligated to pay for the merchandise in accordance with normal trade terms.

.19 Some manufacturers discount the price of records by including a number of "free" records in certain shipments. Credits issued for returned records give recognition to such "free" records either by using the average selling price or by reducing the total units returned in proportion to the number of "free" records included in the original shipment.

.20 Because of the return or exchange privilege, manufacturers and distributors usually make a provision in their financial statements for the anticipated return of records from current and prior sales. The resultant allowance for returns is usually combined with the allowance for doubtful accounts and deducted from trade receivables in the balance sheet. In the income statement, the provision for returns is generally netted against gross sales recorded for the period, but is sometimes classified as "sales returns and allowances." However, in some cases the sales transaction is reversed and an inventory is established. In other cases a liability is accrued for the return privilege. The determination of the amount of anticipated returns is based on many factors, including historical experience, popularity of the music recorded, success of the recording artists, marketing techniques, etc.

.21 Some manufacturers and distributors (who have return privileges with manufacturers) do not provide in their financial statements for return privileges granted to their customers and recognize losses, if any, arising from returns only when they are incurred.

### **The Division's Conclusion**

.22 The question of revenue recognition when right of return exists has been discussed in Statement of Position No. 75-1 [section 10,050] of the Accounting Standards Division of the AICPA. That Statement holds that "... If the seller is exposed to the risks of ownership through return of the property, it



should be presumed that the transactions should not be recognized currently as sales unless *all* of the following conditions are met. . . .” These conditions and their applicability to the record and music industry are discussed below:

“(1) The seller’s price to the buyer is substantially fixed or determinable at the date of exchange.”

Sales prices are normally fixed at the date of exchange in the record and music industry.

“(2) Either the buyer has made full payment, or the buyer is indebted to the seller and payment is not contractually or implicitly excused until such time as the product is resold.”

Payment for merchandise in the record and music industry is usually required within thirty days under the terms of sale, or, in the case of deferred billing, within sixty to ninety days of shipment.

“(3) The buyer’s obligation to the seller would not be changed in the event of theft or physical destruction or damage of the property.”

The risk of loss with respect to record and music merchandise is transferred to the buyer under usual trade practices upon transfer of physical possession of the merchandise.

“(4) The buyer acquiring for resale has economic substance apart from that provided by the seller; that is, the buyer is not a straw party or a conduit.”

It would not be common to find a buyer who is a straw party or a conduit in the record and music industry.

“(5) The seller does not have significant obligations for future performance to bring about resale of the property by the buyer.”

The seller would not normally undertake obligations to bring about resale of the property by the buyer in this industry.

“(6) The amount of future returns can be reasonably predicted.”

Predicting the amount of future returns in the record and music industry can be difficult, as indicated below.

.23 Although each of the conditions listed above must be met and the usual conditions for recording sales not involving the right of return must also be satisfied, the sixth condition is usually the most troublesome.

.24 The Statement of Position acknowledges that the “ability to make a reasonable prediction of the amount of future returns is dependent on the existence of many factors,” and

that "only general guidelines can be established." It lists five factors which "would appear to impair the ability to make a reasonable prediction," all of which must be considered; however, the factor that requires the most consideration in the record and music industry is the following:

"Absence of historical experience with similar types of sales of similar types of property, or inability to apply such experience because of changing circumstances."

.25 Rates of return in the record and music industry vary from company to company and from year to year and very little information is published regarding returns. High volume and reasonably stable rates of return have enabled many established companies to make a reasonable estimate of returns on the basis of their own historical and forecasting experience. However, companies expanding to a different type of music (classical, jazz, rock, etc.) and companies engaging a large number of unproven artists, among others, may not possess sufficient experience of their own on which to make a reasonable estimate of future returns. In those instances, or where a company is new and has no historical experience, reference to the experience of other enterprises, if such experience is applicable and obtained in sufficient detail, may provide useful information in determining a reasonable estimate of returns.

.26 The Division believes that manufacturers and distributors in the record and music industry must be able to make a reasonable estimate of returns in order to account for shipments to customers as sales. This conclusion is consistent with the provisions of paragraph 23 of FASB Statement No. 5 with respect to uncollectible receivables.

.27 Certain types of music may be susceptible to dramatic swings in popularity; artists may have no prior experience and uncertain futures; the market for certain types of music may be monopolized by a few artists; distribution channels may be narrow and promotional endeavors limited; and the quantity of returns may be large when a manufacturer changes a distributor. All of these conditions create difficulty in making a reasonable estimate of the amount of future returns. When the presence of such conditions precludes a manufacturer or distributor from making a reasonable estimate of the amount of future returns, the transaction should not be recognized currently as sales. Transactions for which sales recognition is

postponed should be recognized as sales when the return privilege has substantially expired.

.28 As required by Statement of Position No. 75-1 [section 10,050] amounts of sales revenues and cost of sales reported in the income statement should exclude the portion for which returns are expected and, because sales returns are a significant factor in determining the results of operations in the record and music industry, the amount of gross sales and the related accounting policies should be disclosed.

## **INVENTORY VALUATION**

### **Industry Practice**

.29 Inventory valuation in the record and music industry is difficult because of the severe obsolescence problem resulting from changing consumer tastes and return or exchange practices. This problem is even more pronounced when the inventory valuation of returned records is being determined. For this reason, some companies assign no value to returned records. Others carry them at estimated salvage value, cost, or the lower of cost or market. The valuation policy may depend on whether the records are singles, LP albums or tapes. In addition, the determination of market value is complicated by the existence of two markets: one for the resale of records on a marked-down basis, and another for the scrap value of the physical components.

### **The Division's Conclusion**

.30 The valuation of inventories in this industry should be similar to that of any other manufacturing concern. Inventories should be carried at the lower of cost or market.<sup>2</sup> Inventories of salable records and inventories of records to be scrapped should be separately valued. The market value of records to be scrapped should be their expected net salvage value. Although manufacturing cost is usually minor relative to the selling price of most records, cost may exceed market value when drastic reductions to selling price have been made.

## **COMPENSATION OF ARTISTS**

### **Industry Practice**

.31 As noted elsewhere in this Statement, artists are usually compensated on a royalty basis; the royalty provisions are set

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<sup>2</sup> See ARB No. 43, Chapter 4, for guidance.

forth in the artist's contract and may vary substantially among artists, since they depend on the artist's bargaining power.

.32 Generally, the total amount of royalty accrued (adjusted for anticipated returns) is charged to expense in the period in which the sale of the record takes place. However, the accounting for advances paid to artists which are recoupable (recoverable) out of future royalties is not consistent among companies. The common alternatives are summarized below:

- (1) The advance is recorded as an asset with subsequent royalties earned offset against it until the advance has been fully recovered or determined to be unrecoverable. Some believe this method achieves the best matching of revenue and expense.
- (2) The advance is recorded as an asset but expensed when the record is released. Some believe this is a practical method to achieve a reasonable matching of revenue and expense, since the bulk of record revenues are received in a relatively short period of time.
- (3) The advance is recorded as expense when paid by those who emphasize the difficulty of predicting the sales and returns of a *particular* record.
- (4) The advance is included as part of inventory cost by those who believe that such advances are another element of the cost of producing a record and should be amortized on the same basis as any other recording cost.

### **The Division's Conclusion**

.33 The Division believes that advances should be recorded as an asset (a prepaid royalty, current or noncurrent, as appropriate) when the past performance of the artist to whom the advance is made provides a reasonable basis for estimating that it will be recouped (recovered from future royalties). The advance should be charged to income as subsequent royalties are earned by the artist. However, it is a generally accepted accounting principle that losses should be provided for when they become evident. Therefore, as soon as it is estimated that all or a portion of the unrecouped advance will not be recovered from future royalties earned by the artist, that portion of the advance should be charged to expense.

.34 Management should evaluate the artist's past performance, the success of the particular release, market trends, contractual or other arrangements, and other pertinent information in determining whether the advance is recoverable. The right

to recoup advances from a number of records of an artist may complicate the recoverability determination. However, failure to recover a proportionate amount of the advances from royalties payable on each release would normally establish a presumption that at least a portion of the advance should be written off.

.35 Commitments for artist advances payable in future years and future royalty guarantees should now be disclosed in a note to the financial statements, if material, and evaluated currently to determine if a loss provision is required.

.36 Inasmuch as artist royalties, as well as copyright and other royalties, are generally a significant cost, a careful review of the contracts and possible interpretations thereof is essential to a determination of an appropriate accrual.

## **COSTS OF RECORD MASTERS**

### **Industry Practice**

.37 Under the standard type of artist contract, the cost of producing a record master can be separated into costs borne by the record company and costs recoverable from artists out of designated royalties earned. Typically, the stronger party to the contract bears a lesser portion of the costs; the more successful artists often do not bear any of the costs of record masters. On the other hand, recoupment of costs recoverable from the artist is usually not limited to royalties on a specific record.

.38 The portion of the costs of a record master recoverable from artists is accounted for as a royalty advance using one of the methods discussed in the section on "Compensation of Artists."

.39 Several methods are employed to account for record master costs borne by the record company:

- (1) Record the cost of the record master as an asset and amortize it on the income forecast method. Advocates of this approach believe that it achieves an appropriate matching of income and expense.
- (2) Defer the cost of the record master and charge it to expense in the period of the record's initial release. Supporters of this approach believe that it is a practical method to achieve a reasonable matching of revenues and expense. Since the bulk of record revenues are derived within the first six months of release, they believe this method matches costs with revenues unless the release is near the end of an accounting period.

- (3) Expense the cost of the record master when incurred. Those who believe this approach is appropriate point out the difficulty of predicting the sales of a *particular* record.
- (4) Include the cost of the record master as part of inventory cost. Those who prefer this alternative believe that the cost of a record master is another element of the cost of producing a record and should be amortized on the same basis as any other *recording cost*.

### **The Division's Conclusion**

.40 The Division believes that when the past performance of an artist provides a reasonable basis for estimating that the cost of a record master borne by the record company will be recovered from future sales, that cost should be recorded as an asset and, when material, that asset should be separately disclosed. The cost of record masters should be amortized using a method that reasonably relates the cost of the record master to the net revenue expected to be realized. The Division believes that records, other than those of classical and other music which has achieved sustained public acceptance, have a very short life and costs relating thereto should be amortized accordingly. The portion of the costs recoverable from the artist's royalties should be accounted for as discussed in the preceding section on "Compensation of Artists."

## **LICENSOR INCOME AND LICENSEE COST**

### **Industry Practice**

.41 As noted in a previous section of this Statement, substantial revenues may be realized by the owner of a record master or copyright by licensing it to third parties. Minimum guarantees are usually paid in advance by the licensee. Additional payments are normally required if license fees based on actual sales exceed the minimum guarantee.

Licensors treat such guarantees as either:

- (1) Revenue when received.
- (2) An advance, allocated ratably over the period covered by the guarantee.
- (3) Revenue to the extent of the portion earned during the reporting period, reflecting unearned balances, if any, as income at the expiration of the period covered by the license agreement.

.42 Licensees treat minimum guarantees as costs using similar methods.

.43 When no minimum guarantee is received, or when actual license fees exceed the minimum guarantee, revenue is not normally recognized by the licensor until an accounting is received from the licensee.

.44 In certain situations, other fees may be required under the license agreement. For example, further payments may be required from a record club if it ships "free" records in a quantity which exceeds a specified percentage of sales of the licensor's records over the term of the agreement. Such fees have generally been recorded as revenue by the licensor and as expense by the licensee upon expiration of the agreement.

### **The Division's Conclusion**

.45 The Division believes that in most cases licensors should record minimum guarantees as deferred income to be amortized ratably over the performance period, which is generally the period covered by the license agreement. License agreements for the use of records and music (unlike those, for example, for television exhibition of motion picture films) normally do not specify the total amount of the license fee. Also, the licensor normally has an obligation to furnish music or record masters during the license period. Ratable amortization is appropriate because in many cases it is impossible for the licensor to ascertain whether the actual amount of license income earned under the terms of the agreement exceeds a ratable portion of the minimum guarantee. (This is particularly true with respect to foreign licensees, who frequently do not render accountings on a timely basis.) However, when the licensor can determine that license fees earned under the agreement exceed a ratable portion of the minimum guarantee, it is appropriate to record that greater amount in income.

.46 In some cases, however, a license agreement may, in substance, be an outright sale. When the licensor has signed a noncancellable contract, has agreed to a specified fee, has delivered the rights to the licensee who is free to exercise them, and has no remaining significant obligations to furnish music or records, the earnings process is complete and the fee may be recorded as revenue when collectibility of the full fee is reasonably assured. In such circumstances, neither the licensee's use of the rights transferred nor the passage of time during the license period has any significance in relation to the recognition of revenue by the licensor.

.47 The licensee should record minimum guarantees as a deferred charge which should be expensed in accordance with the terms of the agreement. However, as soon as it is estimated that all or a portion of the minimum guarantee will not be recovered through future use of the rights obtained under the license, that portion of the minimum guarantee should be charged to expense.

.48 The Division believes the licensor should not recognize in revenue the other fees (e. g., those for excess "free" records) discussed previously under "Industry Practice" until the agreement has expired and the amount is fixed and determinable. Prior to the expiration date of the agreement, the licensor normally would have no information as to the number of "free" records distributed. In addition, an estimate of income based on such information, if available, would be contingent on future events. However, the licensee should provide for such expenses on a license-by-license basis for each period covered by the respective financial statements.

.49 Appropriate consideration should be given to matching artist royalties and other costs to recognition of revenue from licensees.

### **INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION**

.50 The acquisition of a record manufacturer or music publisher in a business combination accounted for as a purchase normally entails, among other things, the acquisition of various intangible rights and assets such as record masters, unexpired artist contracts and copyrights. These rights and assets are normally specifically identifiable and have determinable lives and, therefore, should be recorded in accordance with APB Opinion No. 17, paragraphs 24 to 26.

.51 An allocation of the purchase price should be made for financial statement purposes in accordance with APB Opinion No. 16, paragraph 68, based on fair value. (Experience indicates that in many cases no material amount of goodwill results from such allocations.) Appropriate amortization over the useful life (as opposed to the legal life) of each such type of asset should be provided. The benefits expected to be received from such intangible assets may follow an irregular pattern during the estimated lives of those assets. When this is the case, the Division believes that a method of amortization that



reasonably relates the cost of such assets to the net revenue (benefits) expected to be realized is more appropriate than the straight-line method.

### **MUSIC PUBLISHERS**

.52 The problems, practices and recommendations discussed elsewhere in this Statement are applicable to music publishers, where appropriate.

.53 However, the Division recognizes that all or substantially all of a music publisher's revenues are from licensees. The determination of revenue may be difficult since reports from licensees, particularly those in foreign countries, are often delayed. The Division believes that revenue for a period should include reasonable estimates of revenue from each material license for the full period.

### **ACCOUNTING STANDARDS TASK FORCE ON ENTERTAINMENT COMPANIES**

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Director  
Accounting Standards

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**Section 10,120*****Statement of Position 76-2  
Accounting for Origination Costs and  
Loan and Commitment Fees in the Mortgage  
Banking Industry*****[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

August 25, 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 for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry. 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 accounting principles recommended herein are applicable to mortgage banking companies and to divisions of commercial banks and other financial institutions that originate and service loans for other than their own account.


The Statement takes the position that the deferral of any costs of originating mortgage loans in-house (including warehousing and/or marketing costs) should no longer be considered acceptable. However, a portion of the purchase price of certain bulk purchases should be deferred as the cost of the right to receive future servicing revenue. The cost equivalent to one month's interest incurred upon issuance of GNMA securities using the internal reserve method should also be deferred. In each of these cases, according to the Statement, the aggregate amount deferred should not exceed the present value of the amount of future servicing revenue reduced by the present value of expected servicing costs. It is suggested that it is more appropriate to amortize such deferred costs in proportion to the estimated net servicing income from the related mortgage loans.

A mortgage banker can also obtain contractual rights to receive future servicing revenue by acquiring other mortgage banking companies or by acquiring selected servicing contracts. The Statement discusses the appropriate accounting in these circumstances.

The Statement also identifies several different types of loan and commitment fees and suggests appropriate accounting for such fees. In general, these recommendations defer income recognition to a greater extent than is usual in present practice.

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,

A handwritten signature in cursive script that reads "Raymond C. Lauver". The signature is written in dark ink and includes a stylized flourish at the end.

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 FOR ORIGINATION COSTS AND LOAN AND COMMITMENT FEES IN THE MORTGAGE BANKING INDUSTRY

### INTRODUCTION

.01 The Accounting Standards Division of the American Institute of Certified Public Accountants issued a Statement of Position on *Accounting Practices in the Mortgage Banking Industry* on December 30, 1974 (Statement of Position No. 74-12 [section 10,040]) outlining the Division's position on mortgage banker accounting for inventory of permanent mortgage loans held for sale and certain other accounting matters. The Division has also noted that mortgage bankers use a variety of practices to account for loan origination costs and loan and commitment fees and believes that it is desirable to narrow the range of those practices.

.02 The Division's recommendations with respect to accounting for origination costs and loan and commitment fees, as set forth herein, are applicable to financial statements of mortgage bankers that are intended to present financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles. In addition, certain commercial banks and other financial institutions have divisions which conduct operations that are very similar to those performed by mortgage bankers; when such divisions originate and service loans for other than their own account, the accounting principles recommended in this Statement should be followed.

## MORTGAGE BANKING OPERATIONS

.03 Mortgage bankers originate, market and service real estate mortgage loans by bringing potential borrowers and investors together. They originate real estate mortgage loans in order to increase their servicing portfolio and the related servicing income. Many mortgage bankers engage in other related operations, including insurance brokerage, property management, real estate development and sales, management of real estate investment trusts, joint venture investments, and construction lending for residential and commercial development. Mortgage bankers acquire mortgage loans for sale to permanent investors from a variety of sources, including applications received directly from borrowers (in-house originations), purchases from realtors and brokers, purchases from investors and conversions of various forms of interim and construction financing. The mortgage loans are sold to a variety of permanent investors, including insurance companies, pension funds, savings banks, the Federal National Mortgage Association (FNMA), and since 1970 have been placed in trusts to collateralize Mortgage Backed Securities (MBS) guaranteed by the Government National Mortgage Association (GNMA).

.04 Mortgage bankers often originate permanent *residential* loans (one to four family dwellings) without specific commitments from permanent investors to purchase such loans. Since the amount of a typical residential loan is relatively small, mortgage bankers normally obtain block commitments from investors for large dollar amounts of residential loans meeting broad general criteria. However, permanent *commercial* loans are usually large in amount and require careful underwriting and, normally, mortgage bankers will not issue commitments for commercial loans without first obtaining investors' commitments to purchase the specific loans.

.05 Many mortgage bankers solicit land acquisition, development, and construction loans. Mortgage bankers became active in such lending in order to increase their volume of originations of real estate mortgage loans and many, because of the relatively high interest rates associated with such loans, found this activity profitable. These loans generally require the borrower to repay the loan at or shortly after completion of development or construction and, consequently, are usually relatively short-term, seldom exceeding three years.

.06 Mortgage bankers usually retain the right to service the permanent loans which they originate and sell to investors. The loans being serviced are called a loan servicing portfolio. Loan servicing includes, among other functions, collecting monthly mortgagor payments; forwarding payments and related accounting reports to investors; collecting escrow deposits for the payment of mortgagor property taxes and insurance; and paying taxes and insurance from escrow funds when due. The mortgage banker receives a servicing fee, usually based on a percentage of the outstanding principal balance of the loan, for performing these servicing functions. When servicing fees exceed the costs of performing servicing functions the existing contractual rights associated with a servicing portfolio have an economic value, and portions or all of such servicing portfolios have frequently been purchased and sold.

.07 Mortgage bankers have traditionally sold their originated loans individually or in relatively small blocks to a variety of different investors. Recently, however, a growing volume of mortgages have been placed in trusts to collateralize mortgage-backed securities guaranteed by GNMA. Payments to GNMA security holders are made on either the concurrent dates (15 day) method or the internal reserve (45 day) method. When mortgage bankers use the internal reserve method, a cost equivalent to one month's interest, which may be partially recovered in future periods, is incurred upon issuance of the security. There is no such cost associated with securities issued under the concurrent dates method.

## **ORIGINATION COSTS**

### **Background**

.08 Costs of originating mortgage loans in-house include (1) direct personnel expenses, (2) other direct costs, and (3) general and administrative expenses such as occupancy, equipment rental, etc. Mortgage bankers may incur expenses at both home office and branch locations for the purpose of originating loans. Certain of these expenses, such as commissions paid to loan originators, may vary proportionately with origination activity, while other expenses may be more fixed in nature. Some mortgage bankers have indicated that origination fees are adequate to cover direct origination costs; others, particularly those who believe general and administrative and certain other expenses

should be allocated to origination activities, disagree. Identification of the costs of originating specific loans is difficult, and many mortgage bankers do not believe it is necessary to maintain the records required to identify such specific loan costs.

.09 Many mortgage bankers, however, have incurred in-house origination costs in excess of the revenue derived from their origination operations. They originate such loans in order to obtain the increase in servicing revenue resulting from selling the loans to investors while retaining the loans in their servicing portfolio.

.10 Mortgage bankers, in addition to originating mortgage loans in-house, use other methods to increase their servicing portfolios. One method is to acquire, from other companies, existing contractual rights to service specific mortgage loans for investors. This has been accomplished both by acquiring selected servicing contracts and by acquiring other mortgage banking companies. A portion or all of the price has often been allocated both to the right to receive future servicing revenue and to the relationship with new investors, to whom the mortgage banker may more readily sell future mortgage loans because of the servicing relationship. The amortization of the amount allocated to the right to receive future servicing revenue is deductible for income tax purposes while the amount allocated to the relationship with new investors is not.

.11 Another method used to increase servicing portfolios is to make bulk purchases of mortgage loans from governmental agencies, particularly GNMA, and from FNMA and other mortgage companies. Some of these bulk purchases are made only after contracts for sale of the related mortgage-backed security or of the mortgage loans themselves have been negotiated by the mortgage banker with permanent investors. Others are made on a "market risk" basis; that is, the loans are marketed on the same basis as loans originated in-house. Mortgage bankers may enter into these transactions even when they estimate that the costs of the mortgage loans will exceed the subsequent selling prices in order to obtain the future servicing revenue. Such bulk purchases have been fairly rare. However, many mortgage bankers expect GNMA and FNMA to continue to conduct auctions of their mortgages and, therefore, mortgage bankers may make more purchases from FNMA and governmental agencies in the future.



## **Costs of Originating Mortgage Loans In-House**

### **Current Industry Practice**

.12 Under present practices followed by most mortgage bankers for both financial reporting and income tax purposes, all revenue and costs associated with the origination of mortgage loans in-house are reflected in current operations; however, a few companies have begun to defer some of these costs on the basis that such costs were incurred to obtain the related future servicing revenue. The components of origination costs deferred vary from company to company. Some companies consider the origination function completed once a loan is funded by the mortgage banker, while others also include the income and costs associated with the warehousing and/or marketing functions in deferred origination costs.

### **The Division's Position**

.13 In view of (1) the long-standing practice followed by mortgage bankers of expensing costs of originating mortgage loans in-house as incurred, (2) the fact that mortgage bankers receive origination fees as at least partial reimbursement of in-house origination costs, (3) the difficulty in identifying the costs of originating specific loans, and (4) the practice followed by other industries with similar activities (costs are reflected in current operations), the Division believes that the deferral of any costs of originating mortgage loans in-house (including warehousing and/or marketing costs) should no longer be considered acceptable.

## **Bulk Purchases and Sales of Mortgage Loans**

### **Current Industry Practice**

.14 Generally, the revenues and costs associated with the purchase and sale of mortgage loans have been recorded in current operations by mortgage bankers. However, because of the large dollar amounts and because of the similarities to the purchase of servicing contracts (see paragraphs .10 and .18 to .24), many mortgage bankers have treated a portion of the purchase price of bulk purchases of mortgage loans from governmental agencies, particularly GNMA, and from FNMA and other mortgage companies as the cost of acquiring rights to receive future servicing revenue and have deferred such amounts. The portion of the purchase price allocated to these rights has usually been the difference between the total pur-

chase price, including any transfer fees, and either the eventual sales price of the loans or the market value of the loans at the date of purchase. Some mortgage bankers have also deferred processing costs associated with purchasing and selling the loans and any interest spread between the loan rate and their borrowing rate for warehousing the loans during their holding period. All amounts deferred have been amortized to future operations.

### The Division's Position

.15 The Division believes that a portion of the purchase price of certain bulk purchases (usually only purchases from FNMA and GNMA and other governmental agencies) should be deferred as the cost of acquiring rights to receive future servicing revenue associated with the purchased loans when the mortgage banker retains the right to service such loans. The amount deferred should not exceed the excess of the purchase price of the loans, including any transfer fees paid, over the market value of the loans at the date of purchase,<sup>1</sup> subject to the following limitations and conditions:

- (a) At the time the transaction is initiated, there should exist a definitive plan for the sale of the mortgage loans or related mortgage-backed securities. This plan should include estimates of purchase price and selling price with reasonable support for such estimates. A definitive plan is deemed to exist when the mortgage banker (1) has, previous to the date of the bulk purchase, obtained commitments from permanent investors to purchase the mortgage loans or mortgage-backed securities or (2) enters into a commitment within a reasonable period of time (usually not more than thirty days after the date of the bulk purchase) to sell the mortgage loans or mortgage-backed securities to an investor or underwriter.
- (b) The amount deferred should be reduced by any excess of the final sales price to the permanent investor over the market value of the loans at the date of the bulk purchase. The purpose of this requirement is to preclude the deferral of any amount recovered at the date of sale through the sales price.
- (c) No costs associated with the transactions other than those identified above (excess of purchase price, including transfer fees, over market value as defined) should be deferred. Therefore, interest, salary, and general and administrative expenses, for example, should specifically *not* be deferred.

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<sup>1</sup> See the Division's Statement of Position No. 74-12 [section 10,040] for guidelines as to the computation of market value.

- (d) The amount deferred should not exceed the present value of the amount of net future servicing income, determined in accordance with the provisions of paragraph .25.
- (e) No amounts arising from transactions with other mortgage bankers should be deferred unless such purchases from other mortgage bankers are rare and unusual and not in the ordinary course of business. The purpose of this requirement is to preclude the capitalization, through such transactions, of in-house origination costs that should be charged to current operations.

### **Cost Incurred Upon Issuance of Certain GNMA Mortgage-Backed Securities**

#### **Current Industry Practice**

.16 The cost equivalent to one month's interest incurred upon issuance of GNMA securities using the internal reserve method has been expensed by some companies. It has been deferred and amortized by others, on the basis that this cost was incurred to secure future mortgage servicing revenue and might be partially recovered in future periods.

#### **The Division's Position**

.17 The Division believes that the one month's interest cost incurred upon issuance of GNMA securities using the internal reserve method should be deferred and amortized. The aggregate amount deferred (including amounts deferred under other provisions of this Statement of Position) should not exceed the present value of the future net servicing income as determined in accordance with the recommendations in paragraph .25.

### **Costs of Purchasing Existing Contractual Rights to Service Mortgage Loans**

#### **Current Industry Practice**

.18 As discussed in paragraph .10, a mortgage banker may acquire contractual rights to service mortgage loans (i. e., the right to receive future servicing revenue) from other mortgage bankers by acquiring selected servicing contracts or by acquiring the assets or the outstanding stock of the selling company. APB Opinions No. 16 and No. 17 provide guidance as to the appropriate accounting for the costs of the intangible assets resulting from the acquisition of such contractual rights, both those acquired separately and those acquired in connection with a business combination. The costs have often been allo-

cated both to the right to receive future servicing revenue and to the relationship with new investors; such costs have been deferred and amortized to operations over future periods. In business combinations, amounts may also be recorded as goodwill.

.19 The costs allocated to the right to receive future servicing revenue have usually been calculated based upon at least some of the factors mentioned in paragraph .25. The amounts deferred have generally been amortized over the estimated remaining lives of the loans. Costs allocated to the relationship with new investors have usually been amortized over a forty-year period, in conformity with APB Opinion No. 17, since they were presumed to have an indeterminate life.

.20 Amounts recorded as goodwill in connection with business combinations initiated after October 31, 1970, have been accounted for in conformity with APB Opinions No. 16 and No. 17.

#### **The Division's Position**

.21 APB Opinions No. 16 and No. 17 provide guidelines for accounting for business combinations and for intangible assets; it is not the intention of this Statement of Position to modify the provisions of those Opinions.

#### **Servicing Contracts Acquired in a Business Combination**

.22 The Division believes that the right to receive future servicing revenue is an intangible asset of the type discussed in APB Opinion No. 17 and that an allocation of the purchase price to that right is appropriate. In no event, however, should the amount allocated to such a right exceed the present value of the future net servicing income, calculated in accordance with the recommendations in paragraph .25.

.23 When the purchase price includes amounts paid for other intangible assets, those assets should be accounted for in accordance with the applicable provisions of APB Opinions No. 16 and No. 17. One such asset might be a relationship with a new investor. The Division believes, however, that the value of such a relationship in the mortgage banking industry usually cannot be determined, for the following reasons. Although a relationship with a new investor may facilitate future sales to that investor, generally that new investor makes no specific commitment to purchase additional loans from the mortgage

banker and the mortgage banker is not assured of any future sales. Absent such sales, the relationship has, of course, no value. Furthermore, even when the investor agrees to an exclusive territorial relationship with the mortgage banker, the Division believes it is usually not possible to make a reasonable estimate of the volume or price of future loan originations and the amount of the related future servicing revenue.

**Servicing Contracts Acquired  
In Other Circumstances**

.24 When contractual rights to service mortgage loans are acquired other than by a business combination, the Division believes that an allocation of the purchase price should first be made to the right to receive future servicing revenue. This amount should not exceed the present value of the future net servicing income, calculated in accordance with the recommendations in paragraph .25. Any excess of the purchase price over the amount allocated to the right to receive future servicing revenue should be accounted for in accordance with the applicable provisions of APB Opinion No. 17.

**Limitation on Amounts to be Deferred**

.25 Amounts deferred in accordance with paragraphs .15, .17, .22 and .24 that are associated with the right to receive future servicing revenue should not exceed the present value of the amount of future servicing revenue reduced by the present value of expected servicing costs. The estimates of future servicing revenue should include probable late charges and other ancillary income. Servicing costs should include direct costs associated with performing the servicing functions associated with the acquired contractual rights and appropriate allocations of other costs.<sup>2</sup> The rate used to calculate the present value should be an appropriate current interest rate.<sup>3</sup>

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<sup>2</sup> Reference should be made to the Mortgage Bankers Association of America, Inc., suggested chart of accounts for guidance as to the types of revenues and costs to be included. In this connection, the Division believes that servicing costs may be calculated on an incremental cost basis.

<sup>3</sup> The use of an appropriate current interest rate is in accordance with APB Opinion No. 16, paragraph 88. Since servicing income will be recognized over a period of several years, the Division believes that a long-term rate is the most appropriate interest rate to use in calculating the present value of such servicing income.

## **Amortization of Deferred Costs**

### **Current Industry Practice**

.26 The two methods currently used for amortizing deferred costs associated with future servicing revenue are the straight-line and the accelerated methods. Although servicing revenue (other than late charges and certain other related ancillary income) is generally reflected in operations based on a fixed percentage of the unpaid principal balances of the mortgages, a substantial number of mortgage bankers amortize related deferred costs on the straight-line method. Most mortgage bankers using an accelerated amortization method have chosen the sum-of-the-years' digits method. Deferred costs associated with future servicing revenue are usually amortized over the estimated average remaining lives of the related mortgage loans.

### **The Division's Position**

.27 The Division recommends that any deferred costs of rights to receive future servicing revenue and any deferred costs equivalent to one month's interest incurred upon issuance of GNMA mortgage-backed securities using the internal reserve method be amortized in proportion to the estimated net servicing income from the related mortgage loans, because this method relates the amortization to the benefits expected to be received (see paragraph .25). For that reason, the Division believes that the method described is more appropriate than the straight-line method in the mortgage banking industry.

.28 It should be noted that deferred costs are to be amortized over the period of *net servicing income* rather than the period of the *servicing revenue*, since the period estimated to be benefited by the deferred costs is the period of net servicing income.

## **LOAN AND COMMITMENT FEES**

### **Background**

.29 Mortgage bankers frequently charge borrowers fees in addition to the interest charges on the funds advanced. While the types of fees charged may vary and are limited only by the imagination of borrowers and lenders, loan fees can be identified as one or more of the following:

- (a) A fee which in reality is an adjustment of the interest rate.
- (b) A fee received as compensation to the lender for earmarking funds so that they will be available to the borrower when required. Maintaining such funds in a liquid position may result in a lower yield than could be real-

ized absent the need for liquidity. Also, the lender may need available lines of credit to call upon to honor his commitments, and various costs are normally incurred to maintain such available credit.

- (c) A fee received to guarantee the borrower an interest rate at or near the market rate at the time the commitment is issued. The fee is charged to compensate the lender for taking the risk that the market rate of interest for the individual borrower when the loan is funded will be higher than the commitment rate.
- (d) A fee to compensate the lender for underwriting and processing the loan.
- (e) A fee received to provide a construction lender with assurance that he will be repaid. Such fees are frequently called "standby" or "gap" commitment fees. The related loan commitments are usually not expected to be funded. "Standby" commitments are normally issued to enable the borrower to obtain construction loans from a lender who is unwilling to provide such financing without the protection of a commitment for permanent financing which will repay the construction loan. Such commitments normally provide for an interest rate substantially above the market rate in effect at the time of issuance of the commitment. Commitment fees may also relate to the issuance of a commitment to loan funds to cover possible cost overruns or to provide intermediate term "gap" financing while the borrower is in the process of satisfying provisions of the permanent financing agreement, such as obtaining designated occupancy levels on an apartment project.
- (f) A fee received for performing other services.

.30 In addition to collecting fees, mortgage bankers often pay fees to obtain commitments from permanent investors to purchase mortgage loans from the mortgage banker.

.31 Mortgage bankers have followed a number of methods for recognition of income from loan fees, including the following:

- (a) Immediate recognition upon receipt
- (b) Deferral with amortization—
  - (1) over the commitment period
  - (2) over the combined commitment and loan period
  - (3) over the loan period
- (c) Deferral without amortization with recognition in operations when it is clear that the commitment will not be funded
- (d) Deferral until loan is repaid or sold.

### The Division's Position

.32 The terminology applied by mortgage bankers to the fees which they receive varies widely. The selection of the most appropriate treatment for a loan fee should be based not on its descriptive title but on an analysis of the nature and substance of the related transaction. The Division believes that all fees received by mortgage bankers as a result of their loan origination activities should be accounted for in accordance with the recommendations in the following paragraphs.

.33 The Division believes that loan fees collected by mortgage bankers generally represent compensation for a combination of services and may include, for example, an adjustment of the interest rate on the loan, a fee for earmarking funds, and/or an offset of underwriting costs. The Division also believes it is not practicable to separate a loan fee into its components and, therefore, recommends that such fees be accounted for in accordance with their primary purpose as outlined below.

(a) Residential Loan Origination Fees—

Mortgage bankers usually collect origination fees for residential loan originations. The Division believes that the normal residential origination fee is essentially a reimbursement for the costs of the underwriting process of obtaining appraisals, processing the loan application, reviewing legal title to the real estate, and other procedures. The Division believes such fees, to the extent they are a reimbursement for such costs, should be recognized in income as they are collected, since the costs of these services are charged to expense as incurred. Any fees in excess of this amount should be treated as commitment fees. Since the identification of origination costs is extremely difficult (see paragraph .08), the Division believes that fees in an amount not in excess of the allowable FHA and VA rates may be recorded as income at loan closing, because fees based on such rates will generally not exceed origination costs.

(b) Residential Loan Commitment Fees—

In addition to the origination fees, mortgage bankers often charge a commitment fee to the borrower or to a builder/developer to guarantee the funding of loans. In addition, the mortgage banker often pays commitment fees to permanent investors to ensure the ultimate sale of the funded loans. Normally these commitment fees (both received and paid) relate to blocks of loans for a specified total dollar amount. The Division believes that both the commitment fees paid and those received should be de-



ferred. They should be recognized in operations upon completion of the sale of the loans to the permanent investor or when it is evident that the commitment will not be used. If the commitment fees paid or received relate to a commitment amount for a block of loans, the portion of the fees recognized in operations as the result of an individual loan transaction should be based on the ratio of the individual loan amount to the total commitment amount.

**(c) Commercial Loan Placement Fees—**

Mortgage bankers may receive fees for arranging a commitment directly between a lender and a borrower. Additionally, mortgage bankers sometimes issue commitments in their own name which contain clauses making the loan funding contingent upon simultaneous funding of the loan by a permanent investor. The Division believes that if the mortgage banker has obtained a commitment from an investor prior to making his own commitment, and if his own commitment to the borrower requires simultaneous assignment to and funding by the investor, the transaction is in substance a loan placement transaction. In transactions of either of these types, the Division believes that the mortgage banker is serving only as a conduit between lender and borrower and the fees received should be recognized in operations when the mortgage banker has no remaining significant obligations for performance in connection with the transaction.

**(d) Commercial Loan Commitment Fees—**

Commitments to fund a loan on an income-producing or commercial property frequently have longer terms than those associated with residential loans. The fees from such commitments generally involve larger dollar amounts and they vary more widely as a percentage of the loan amount than residential loan fees. The Division believes that commitment fees received and paid in connection with a commercial permanent loan should be deferred and recognized in income upon completion of the sale of the loan to the permanent investor.

**(e) Land Acquisition, Development, and Construction Loan Fees—**

The Division believes that such loan fees should be deferred and recognized as income over the combined commitment and loan period. The straight-line method of amortization should be used until funding begins; the interest method should be used for the remaining unamortized balance during the loan period. The commitment and loan period of a construction or development loan is directly related to the length of the construction or development period, which is affected by many variable

factors. The best estimate of such period should be utilized. In the event of a significant revision to the original estimate of the period, the unamortized portion of the commitment fee at the time of revising the estimate should be amortized ratably over the revised period. Any subsequent fees collected as a result of changes in the period should likewise be amortized over the revised period.

(f) Standby and Gap Commitment Fees—

The Division believes that because the potentially volatile nature of the market for real estate loans may require the funding of standby and gap commitments, fees for such commitments should be recognized as income over the combination of the commitment and standby or gap loan period. The straight-line method of amortization should be used during the commitment period and the interest method should be used for the remaining unamortized balance during the loan period if the loan is funded. Any additional fees collected at the time of funding the loan should be amortized over the loan period.

(g) Fees for Services Rendered—

In some cases mortgage bankers will collect fees solely for providing services with respect to the origination of a loan, such as appraisals, etc. The Division believes that such fees should be recognized in operations when the services have been performed.

.34 In recognizing loan fees as income, consideration must be given to the collectibility of the fee. If the fee has not been received in cash, there must be evidence that its collectibility is reasonably assured.

.35 When commitments expire without being funded or loans are repaid prior to the estimated repayment date, the Division believes any unamortized loan fees should be recognized in operations at that time.

**ACCOUNTING STANDARDS DIVISION**

**Accounting Standards Executive Committee**

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Charles Chazen	Harry F. Reiss, Jr.
Harold Cohan	Edward J. Silverman
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**Accounting Standards Task Force on  
Mortgage Bankers**

Alvin Zuckerkorn, Chairman	James H. Hammond, Jr.
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**AICPA Staff**

Thomas P. Kelley, Director  
Accounting Standards

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➡ *The next page is 18,231.* ←



**Section 10,130*****Statement of Position 76-3  
Accounting Practices for  
Certain Employee Stock  
Ownership Plans*****[Recommendation to the Financial Accounting Standards Board]****AICPA****American Institute of Certified Public Accountants**

1211 Avenue of the Americas New York New York 10036 (212) 575 6200

December 20, 1976

Marshall S. Armstrong, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices for Certain Employee Stock Ownership Plans (ESOPs). It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement deals primarily with accounting and reporting issues that have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company or that issue notes to existing shareholders in exchange for shares of stock. However, certain conclusions in the Statement are also applicable to ESOPs that have not entered into such transactions.

The Statement's major recommendations are briefly summarized below:

- An obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements.
- The offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity.

- The liability recorded by the employer and the offsetting debit should both be reduced as the ESOP makes payments on the debt.
- The amount contributed or committed to be contributed to an ESOP with respect to a given year should be charged to expense by the employer; the compensation and interest elements of the contribution should be separately reported.
- All shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. Dividends paid on those shares should be charged to retained earnings.
- Any additional investment tax credit should be accounted for as a reduction of income tax expense in the year in which the contribution to the ESOP is charged to expense.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,



Raymond C. Lauver  
Chairman  
Accounting Standards Division

cc: Securities and Exchange Commission

#### 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."<sup>1</sup> Qualifying employer securities include the employer's stock and its other marketable obligations. The essential differences between an ESOP and other qualified stock bonus plans are that (a) an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities and (b) the employer may be permitted to increase his maximum allowable investment tax credit by as much as an additional 1½% if that amount is contributed to an ESOP.

.02 In some cases, funds are borrowed from a bank or other lender by the ESOP and are used to acquire shares of stock in the employer company. The stock may be outstanding shares, treasury shares, or newly issued shares, and is held by the ESOP until it is distributed to the employees. (In some cases, an ESOP may issue notes to existing shareholders in exchange for qualifying employer securities.) The stock may be allocated to individual employees even though it may not be distributed to them until a future date. The debt of the ESOP is usually collateralized by a pledge of the stock and by either a guarantee of the employer or a commitment by the employer to make

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<sup>1</sup> 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.<sup>2</sup> These issues are being dealt with in practice in different ways. This Statement of Position has been issued because the Division believes it is desirable to narrow the range of alternative accounting practices in this area.

.04 Final regulations clarifying the rights and duties of the parties affected by an ESOP have not been issued by the Internal Revenue Service. Readers of this Statement of Position should also be cognizant of the content of such regulations, when they are issued.

### **ACCOUNTING FOR AN OBLIGATION OF AN ESOP GUARANTEED BY THE EMPLOYER**

#### **Recording an ESOP's Obligation in the Employer's Financial Statements**

.05 The Division believes that an obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the

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<sup>2</sup> This Statement of Position does not deal directly with ESOPs that might invest in qualifying employer securities other than equity securities.



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.<sup>3</sup> Such contributions measure the amount of expense irrevocably incurred whether or not they are used concurrently to reduce the debt guaranteed by the employer.

.10 Since the debt of the ESOP is, in substance, the employer's debt, the Division believes that the employer should report separately the compensation element and the interest element of the annual contribution, and should disclose the related interest rate and debt terms in the footnotes to the financial statements. However, a significant minority within the Division believes that the entire annual contribution should be reported as compensation expense.

### **REPORTING DIVIDENDS PAID AND EARNINGS PER SHARE**

.11 The Division believes that all shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. An ESOP is a legal entity holding shares issued by the employer, whether or not those shares have been allocated to employee accounts.

.12 Dividends paid on shares held by an ESOP should be charged to retained earnings. Such dividends should not be included at any time in compensation expense.

.13 A minority within the Division believes that when trust debt proceeds are transferred to the employer corporation, a transaction of a predominantly financing nature has occurred. The minority believes that shares should be considered outstanding for earnings per share calculations only to the extent that they become constructively unencumbered by repayments of debt principal. To do otherwise, according to this minority view, would result in an inconsistent and initially excessive effect on earnings per share in that the total number of shares purchased by the ESOP would be immediately included in the calculation of earnings per share, even though the related compensation expense would be spread over a period of time on the basis of the employer's contribution to the trust. Consistent with this position, the minority would also charge dividends to retained earnings only to the extent that trust shares are unencumbered. Any remaining balance would be reported as additional compensation expense in the period the dividends were declared.

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<sup>3</sup> This conclusion is also applicable to ESOPs that have not borrowed funds from a bank or other lender (or issued notes to existing shareholders) to acquire shares of stock in the employer company.

## 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.<sup>4</sup> This additional credit arises from the contribution to the ESOP, not solely from the property acquisitions of the employer.<sup>5</sup>

### Applicability of APB Opinion No. 11

.15 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.<sup>6</sup>

## ACCOUNTING STANDARDS DIVISION

### Accounting Standards Executive Committee

Raymond C. Lauver, Chairman	Robert S. Kay
Hector R. Anton	Robert G. McLendon
Dennis R. Beresford	Donald F. Moran
Charles Chazen	Lewis E. Rossiter
Harold Cohan	Edward J. Silverman
William H. Conkling, Jr.	George R. Vogt
William C. Dent	Charles A. Werner
	Arthur R. Wyatt

### Accounting Standards Task Force On Employee Stock Ownership Plans

Harry F. Reiss, Jr., Chairman	Fred L. Tepperman
	George R. Vogt

### AICPA Staff

Thomas P. Kelley, Director  
Accounting Standards

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<sup>4</sup> See footnote 3.

<sup>5</sup> See also Section 101(c) of the Revenue Act of 1971.

<sup>6</sup> 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**

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

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.

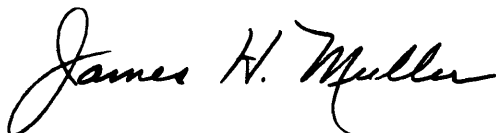
The advent of listed options has increased trading volume significantly, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Statement recommends that the sections of the Guide dealing with put and call options should be 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

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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.

Accounting Standards Task Force  
on Investment Companies

JAMES H. MULLER, <i>Chairman</i>	WILLIAM T. KENNEDY
CHARLES ADAMS	DAVID A. O'KEEFE
EDWARD L. CAMERON	FRANK H. TIEDEMANN
PHILLIP L. COHEN	JOHN WOODCOCK, JR.
S. LELAND DILL	
FRANK T. GIANNETTA	
EDWIN N. HANLON	

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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.<sup>1</sup> 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.

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<sup>1</sup> 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).

<b>From Investment Activities</b>	<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	\$ 99,000	\$80,000
Dividends declared	99,500	80,000
Decrease in assets derived from investment activities <sup>2</sup>	\$ (500)	—

.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.

<b>From Investment Activities</b>	<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	\$102,000	\$79,000
Dividends declared	(102,000)	(79,000)
Increase (decrease) in unrealized appreciation of investments	(3,000)	1,000
Increase (decrease) in net assets derived from investment activities	\$ (3,000)	\$ 1,000

<sup>2</sup> 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.<sup>3</sup> 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.

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<sup>3</sup> 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.<sup>4</sup>

**.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

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<sup>4</sup> 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.

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➡ *The next page is 18,301.* ←

**Section 10,150*****Statement of Position 77-2  
Accounting for Interfund  
Transfers of State and Local  
Governmental Units*****[Proposal to Financial Accounting Standards Board to Amend AICPA  
Industry Audit Guide on Audits of State and  
Local Governmental Units]****AICPA****American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

September 1, 1977

Marshall S. Armstrong, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying statement of position, prepared by the AICPA State and Local Government Accounting Committee, proposes amendments to the AICPA Industry Audit Guide on Audits of State and Local Governmental Units. The statement of position will amend part of chapter 2 of the guide which deals with interfund transfers of state and local governmental units.

Members of the committee will be glad to meet with you or your representatives to discuss this proposal. The committee would also appreciate being advised as to the board's proposed action on its recommendations.

Sincerely yours,

*Frank S. Belluomini*

Frank S. Belluomini, Chairman  
State and Local Government  
Accounting Committee

cc: Securities and Exchange Commission

»»»→ The next page is 18,303. ←«««





#### 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, subcommittees, or 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 task force, subcommittee, or 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 such matters, members should be aware that they may be called upon 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 subcommittee believes would be in the public interest.

## ACCOUNTING FOR INTERFUND TRANSFERS OF STATE AND LOCAL GOVERNMENTAL UNITS

### Proposed Amendment to Industry Audit Guide

#### BACKGROUND INFORMATION

.01 Chapter 2 of the AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*, includes accounting guidelines for four categories of interfund transfers. The first category comprises transactions that would be treated as revenues or expenditures had they been conducted with outsiders. These transfers are accounted for as revenues of the recipient fund and expenditures of the disbursing fund. The second category comprises reimbursements of expenditures made by one fund for another. The reimbursement reduces the expenditures of the recipient fund. The third category comprises recurring annual transfers between two or more budgetary funds for shifting resources from a fund legally required to receive revenue to a fund authorized to expend the revenue. These transfers are shown as separate items in each fund's statement of revenues and expenditures or equivalent financial statement. The fourth category comprises nonrecurring transfers between funds that

are analogous to capital transactions and that represent a transfer of equity of the funds involved. These transfers are treated as direct additions to or deductions from the fund balances.

.02 After publication of the guide, questions arose concerning which category covers those transfers between a general or special revenue fund and an enterprise fund that subsidize the operations of the recipient fund. Such transfers are similar to those covered by the third category. The guide limits the third category to budgetary funds, and to recurring transfers; however, the transfers in question involve enterprise funds and may or may not recur.

.03 The Committee on State and Local Government Accounting believes that the third category should include transfers between funds other than budgetary funds, particularly transfers between a general or special revenue fund and an enterprise fund. The committee also believes that the category should not be restricted to recurring annual transfers.

### RECOMMENDATION

.04 The committee believes that *Audits of State and Local Governmental Units* should be amended by replacing paragraph 3, page 11, with the following paragraph:

3. The third category includes all transfers except those covered in categories 1 and 2, above, and those representing nonrecurring transfers of equity (category 4, below). Typically these represent legally authorized transfers from a fund receiving revenue to a fund that will use the amount transferred. Some examples are as follows:
  - a. Annual transfers from a state's general fund to the state's school aid fund.
  - b. Budgeted transfers from the general fund to a capital projects fund. Expenditure from the capital projects fund of the transferred monies may occur in the year of transfer or in subsequent years.
  - c. Transfers from the general fund or a special revenue fund to an enterprise fund that serves as a subsidy for the operations of the enterprise.

- d. Transfers from an enterprise fund, other than payments in lieu of taxes, to the general fund that serve as a resource for general fund expenditures.

The transfers received and made should appear as separate items in each fund's statement of revenue, expenditures, and transfers or equivalent financial statement. (See "Illustrative Forms of Certain Financial Statements and Supplemental Schedules of Governmental Units," example 5, p. 103.) For enterprise funds, such transfers should appear on the income statement after net operating income or loss.

## ACCOUNTING STANDARDS DIVISION

### State and Local Government Accounting Committee

Frank S. Belluomini,  
*Chairman*

Joseph Antonello, Jr.  
Herman O. Coleman  
James R. Fountain, Jr.

Leon E. Hay

Bruce M. Heider

Nathan Honig

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William D. Mahaney

George L. Patterson, Sr.

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#### *AICPA Staff:*

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*Accounting Standards*

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## 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. ←➡➡



### 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 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.

## 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.<sup>1</sup>

.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).

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<sup>1</sup> 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**

Albert A. Cardone,  
*Chairman*

Ronald B. Ashworth

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Charles K. Bradford

John E. Buelt

Edward B. Hinker

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*Federal Government Division*

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.

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## 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 cursive script, reading "Arthur R. Wyatt".

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 10,180*****Statement of Position 78-3  
Accounting for Costs to Sell and Rent,  
and Initial Rental Operations of,  
Real Estate Projects***

**[A Proposed 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

June 30, 1978

Donald J. Kirk, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

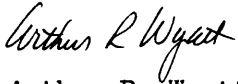
Dear Mr. Kirk:

The accompanying draft of the statement of position, Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects, has been prepared on behalf of the accounting standards division by the AICPA committee on real estate accounting and approved by the accounting standards executive committee.

The statement presents the division's recommendations on accounting for costs to sell and costs to rent real estate projects during their selling or renting phases. It also presents the division's recommendations on accounting for costs and revenues during the initial operating period of a rental project—the period before occupancy stabilizes (sometimes referred to as the "rent-up" period).

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely,

A handwritten signature in cursive script, reading "Arthur R. Wyatt".

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 FOR COSTS TO SELL AND RENT, AND INITIAL RENTAL OPERATIONS OF, REAL ESTATE PROJECTS

.01 The accounting standards division has noted that diverse practices are followed in accounting for both costs to sell and costs to rent real estate projects. It has also noted that diverse practices are followed in accounting for costs and revenues during the initial operating period of a rental project, before occupancy stabilizes (sometimes referred to as the "rent-up" period). The division believes that narrowing the range of those practices is desirable. This statement of position sets forth the division's recommendations on accounting for costs to sell and costs to rent real estate projects and for initial rental operations of such projects.

.02 This statement does not apply to—

- Accounting for depreciation, carrying costs, or operations of real estate projects being accounted for as held for sale.
- "Initial direct costs" (as defined in FASB Statement no. 17, *Accounting for Leases—Initial Direct Costs*) of sales-type, operating, and other types of leases, the accounting for which is prescribed in FASB Statement no. 13.
- Costs directly related to manufacturing, merchandising, or service activities ("commercial activities") as distinguished from real estate activities.
- Real estate rental activity in which the predominant rental period is less than one month.

This statement does not modify the accounting methods for retail land sale companies as prescribed in the AICPA industry accounting guide, *Accounting for Retail Land Sales*.

.03 In the absence of contrary evidence, the representations of the owners of a real estate project concerning whether the project is held for sale or held for rental should govern the accounting for the project under the provisions of this statement. If the owners represent that a portion of a real estate project will be held for sale and a portion will be held for rental, the costs of the project should be allocated to the two portions, each of which should be accounted for as a separate project. An example of such a project would be a building with commercial facilities held for rental on its lower floors and condominium units held for sale on its upper floors. If any portion of a real estate project that the owners represented as being held for sale is rented and the rental is not clearly incidental or temporary, the unsold portion of the project should be accounted for as being held for rental.

### **COSTS INCURRED TO SELL REAL ESTATE PROJECTS**

#### **Present Practices**

.04 Costs to sell real estate projects are accounted for in one or more of the following ways:

1. As project costs, which are capitalized as part of construction costs.
2. As prepaid expenses or deferred charges, which are deferred and amortized over future periods.
3. As period costs, which are charged to expenses as they are incurred.

The criteria governing the selection of those methods vary among companies.

#### **Recommended Practices**

.05 The following paragraphs set forth recommended criteria within the framework of present generally accepted accounting principles (see the appendix to this statement for selected accounting literature) to govern the selection of the methods described above and provide examples of the application of those criteria.

**.06 Project Costs.** Costs to sell real estate projects, less amounts recovered from incidental operations or sales, should be classified with, and accounted for in the same manner as, construction costs if they meet both of the following criteria:<sup>1</sup>

1. The costs are incurred (a) for tangible assets that are used directly throughout the selling period to aid in the sale of the project or (b) for services that have been performed to obtain regulatory approval for sales.
2. The costs are reasonably expected to be recovered from sales of the project or from incidental operations.

Examples of costs that ordinarily meet the criteria for project costs include the costs of model units and their furnishings, sales facilities, legal fees for preparation of prospectuses, and semipermanent signs.

**.07 Prepaid Expenses.** Costs to sell real estate projects should be accounted for as prepaid expenses if they (1) do not meet the criteria for project costs and (2) are incurred for goods or services before the goods are used or before the services are performed. Examples of costs that ordinarily meet the criteria for prepaid expenses include costs of future advertising, unused selling brochures, and commission advances. Prepaid expenses that are identifiable with specific future revenue should be charged to expenses in the periods in which the related revenue is recognized as earned. Prepaid expenses that are associated with future periods but not with specific future revenue should be charged to expenses in the periods of expected benefit.

**.08 Period Costs.** Costs to sell real estate projects that do not meet the criteria for project costs or prepaid expenses should be accounted for as period costs and charged to expenses as incurred. The benefit of those costs usually is limited to the period in which they are incurred; such costs usually provide little discernible future benefits. Examples of costs that should be accounted for as period costs include costs of advertising that have appeared in the media, sales salaries and sales overhead, and “grand openings.”

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<sup>1</sup> For purposes of this statement, costs to sell real estate projects do not include the costs of amenities, such as golf courses and marinas.

## **COSTS INCURRED TO RENT REAL ESTATE PROJECTS**

### **Present Practices**

.09 At present, costs to rent real estate projects under operating leases may be deferred to future periods or charged to expenses as incurred. Generally accepted criteria to govern the choice between the two methods have not been established.

### **Recommended Practices**

.10 The following paragraphs set forth recommended criteria within the framework of present generally accepted accounting principles (see the appendix to this statement for selected accounting literature) to govern the selection of the methods used to account for costs to rent real estate projects under operating leases and provide examples of the application of those criteria.

.11 *Rental Costs Chargeable to Future Periods.* Costs to rent real estate projects under operating leases should be deferred and charged to expenses in future periods if they are incurred for goods or services before the goods are used or before the services are performed or if they are associated with, and their recovery is reasonably expected from, future rental operations.<sup>2</sup> Such costs should be classified in accordance with the nature of the expenditure. Examples of costs that ordinarily should be deferred and charged to expenses in future periods include costs of model units and their furnishings, rental facilities, semipermanent signs, and unused rental brochures.

.12 Deferred rental costs that are directly related to revenue from a specific operating lease should be amortized over the lease term. Deferred rental costs that are not directly related to revenue from a specific operating lease should be amortized to expenses over the period of expected benefit; the period of amortization should begin when the project is substantially completed and held available for occupancy. Estimated unrecoverable amounts of unamortized deferred rental costs associated with a lease or group of leases should be charged to expenses when it becomes probable that the leases will be terminated.

.13 *Rental Costs Chargeable to the Current Period.* Costs to rent real estate projects that do not meet the criteria for rental costs chargeable to future periods should be accounted

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<sup>2</sup> For the purposes of this statement, costs to rent real estate projects do not include the costs of amenities, such as golf courses and marinas.



for as period costs and charged to expenses as incurred. Examples of costs that should be accounted for as period costs include costs of advertising that has appeared in the media, rental salaries and rental overhead, and “grand openings.”

## **INITIAL RENTAL OPERATIONS**

### **Present Practices**

.14 As previously noted, companies follow diverse practices in accounting for costs and revenues during the initial operating period of a rental project. Some consider the initial operating period to extend until a project has reached a predetermined level of occupancy, others, until certain events take place (for example, until the owners obtain permanent financing), and others, until the end of a specified period.

.15 Some companies follow the practices of capitalizing carrying costs and operating expenses net of revenues and of not recording depreciation, or of capitalizing depreciation that is recorded, until the end of the initial operating period as variously defined. They believe that reporting operating losses during the initial operating period is not appropriate when such losses are anticipated and are reasonably expected to be recovered from future rental operations.

.16 Others follow the practice of capitalizing carrying costs and operating expenses only until a rental project is capable of producing revenues and then begin recording carrying costs, depreciation, and operating expenses in operations. They believe that the rental, occupancy status, or age of a rental project should not affect the accounting for the results of operations. They believe that the operating period starts for accounting purposes once a rental project is substantially completed and held available for occupancy or is actually occupied.

### **Recommended Practices**

.17 Certain costs incurred during construction, before a rental project is capable of producing revenue, may be capitalized, and that practice is supported by ample precedents. However, once major construction activity is completed and the project is capable of producing revenue, a rental project should be considered substantially completed and held available for occupancy. The accounting standards division believes that at that stage a change in the status of the rental project has taken

place and that the owner's principal activities are substantially different from those during the construction period. Therefore, the accounting for costs and revenues should reflect the change in status of the project, as set forth in the following paragraphs.

.18 For purposes of this statement, a rental project is "substantially completed and held available for occupancy" if it meets both of the following conditions:

1. Construction has reached the stage of completion at which the builder originally intended to cease major construction activity, as distinguished from activity such as routine maintenance and cleanup.
2. Units are being or have been offered for rental.

.19 Portions of a rental project may be substantially completed and occupied by tenants or held available for occupancy, and other portions may not have reached that stage. Under those circumstances, costs incurred should be allocated between the portions under construction and the portions substantially completed and held available for occupancy, and each portion should be accounted for as a separate project.<sup>3</sup>

.20 Construction activity on a rental project may be suspended before the entire project is substantially completed and held available for occupancy for reasons such as insufficient rental demand. Conditions such as insufficient rental demand may indicate an impairment of the carrying value of a project that is other than temporary, whether or not they lead to suspension of construction. If it is concluded that such an impairment has occurred, an appropriate provision for losses should be recorded. Also, suspension of construction because of insufficient rental demand should, in the event carrying costs are being capitalized, cause a reevaluation of that accounting policy.

.21 The accounting standards division believes that, for a rental project that is substantially completed and held available for occupancy, rental revenues and operating costs should be recorded in income and expenses as they accrue. Amortization of costs to rent the project should be recorded in accordance with the recommendations in the section of this statement on rental costs chargeable to future periods.

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<sup>3</sup> A portion of a rental project accounted for as a separate project is "a rental project" for the purpose of this statement.

.22 A minority of the accounting standards executive committee believes depreciation charges for a rental project that is substantially completed and held available for occupancy should be based on the greater of (1) the portion of the project that is actually rented or otherwise occupied or (2) the portion of the project that the owner anticipated would be rented based on his original projection for rental achievement. However, in the absence of persuasive evidence to the contrary, depreciation should be provided for the total rental project no later than two years following the date the rental project becomes substantially completed and held available for occupancy. The minority believes that the occupancy status of a rental project is an important factor in accounting for depreciation and that the advocated method of phasing in depreciation based on occupancy status results in a proper matching of cost and revenue as anticipated at the rental project's inception.

.23 The accounting standards division believes the useful life of a rental project begins to expire when it is substantially completed and held available for occupancy. Accordingly, at such time, depreciation on the cost of the entire project should be provided by charges to expenses.

.24 The division believes that, because of the project's changed status, all carrying costs applicable to the project, such as real estate taxes, should be charged to expense once a project is substantially completed and held available for occupancy.

## **TRANSITION**

.25 The division recommends the application of the provisions of this statement on a prospective basis to costs to sell and costs to rent real estate projects incurred during fiscal years beginning after June 30, 1978, and for initial rental operations for projects that become substantially completed and held available for occupancy during fiscal years beginning after June 30, 1978. Earlier application is encouraged for fiscal years beginning before July 1, 1978, for which financial statements have not been issued.

## **APPENDIX**

### **Selected Accounting Literature**

.26 The three pervasive expense recognition principles are discussed in paragraphs 155 and 156 of Accounting Principles

Board Statement no. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*:

Expenses are the costs that are associated with the revenue of the period, often directly but frequently indirectly through association with the period to which the revenue has been assigned. Costs to be associated with future revenue or otherwise to be associated with future accounting periods are deferred to future periods as assets. Costs associated with past revenue or otherwise associated with prior periods are adjustments of the expenses of those prior periods. The expenses of a period are (a) costs directly associated with the revenue of the period, (b) costs associated with the period on some basis other than a direct relationship with revenue, and (c) costs that cannot, as a practical matter, be associated with any other period.

Three pervasive expense recognition principles specify the bases for recognizing the expenses that are deducted from revenue to determine the net income or loss of a period. They are "associating cause and effect" "systematic and rational allocation," and "immediate recognition."

.27 Paragraph 161 of Accounting Principles Board Statement no. 4 discusses the application of expense recognition principles:

To apply expense recognition principles, costs are analyzed to see whether they can be associated with revenue on the basis of cause and effect. If not, systematic and rational allocation is attempted. If neither cause and effect associations nor systematic and rational allocations can be made, costs are recognized as expenses in the period incurred or in which a loss is discerned. Practical measurement difficulties and consistency of treatment over time are important factors in determining the appropriate expense recognition principle.

.28 Associating cause and effect (often referred to as the "matching" process) is commented on in paragraph 157 of Accounting Principles Board Statement no. 4:

Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

.29 Paragraphs 159 and 160 of Accounting Principles Board Statement no. 4 discuss the procedures followed in the absence of a presumed direct association with specific revenue:

If an asset provides benefits for several periods, its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect. The cost of an asset that provides benefits for only one period is recognized as an expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assump-

tions about the pattern of benefits and the relationship between costs and benefits because neither of these two factors can be conclusively demonstrated. The allocation method used should appear reasonable to an unbiased observer and should be followed systematically. Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance. Systematic and rational allocation of costs may increase assets as product costs or as other asset costs rather than increase expenses immediately, for example, depreciation charged to inventory and costs of self-constructed assets. These costs are later recognized as expenses under the expense recognition principles.

[The immediate recognition] principle of expense recognition results in charging many costs to expense in the period in which they are paid or liabilities to pay them accrue. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts. The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense, for example, a patent that is determined to be worthless.

.30 The term "initial direct costs" is defined in paragraph 8 of FASB Statement no. 17, *Accounting for Leases—Initial Direct Costs*, as follows:

[Initial direct costs are] those costs incurred by the lessor that are directly associated with negotiating and consummating completed leasing transactions. Those costs include, but are not necessarily limited to, commissions, legal fees, costs of credit investigations, and costs of preparing and processing documents for new leases acquired. In addition, that portion of salespersons' compensation, other than commissions, and the compensation of other employees that is applicable to the time spent in the activities described above with respect to completed leasing transactions shall also be included in initial direct costs. That portion of salespersons' compensation and the compensation of other employees that is applicable to the time spent in negotiating leases that are not consummated shall not be included in initial direct costs. No portion of supervisory and administrative expenses or other indirect expenses, such as rent and facilities costs, shall be included in initial direct costs.

Paragraph 17(c) of FASB Statement no. 13, *Accounting for Leases*, requires that lessors account for "initial direct costs" of sales-type leases as follows:

The present value of the minimum lease payments (net of executory costs, including any profit thereon), computed at the interest rate implicit in the lease, shall be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any initial direct costs (as defined in paragraph 5(m)), less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, shall be charged against income in the same period.

Paragraph 18(b) of FASB Statement no. 13 requires that lessors account for "initial direct costs" of direct financing leases as follows:

The difference between the gross investment in the lease in (a) above and the cost or carrying amount, if different, of the leased property shall be recorded as unearned income. The net investment in the lease shall consist of the gross investment less the unearned income. Initial direct costs (as defined in paragraph 5 (m)) shall be charged against income as incurred, and a portion of the unearned income equal to the initial direct costs shall be recognized as income in the same period. The remaining unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease. However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method in the preceding sentence. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. Contingent rentals, including rentals based on variables such as the prime interest rate, shall be credited to income when they become receivable.

Paragraph 19(c) of FASB Statement no. 13 requires that lessors account for "initial direct costs" of operating leases as follows:

Initial direct costs shall be deferred and allocated over the lease term in proportion to the recognition of rental income. However, initial direct costs may be charged to expense as incurred if the effect is not materially different from that which would have resulted from the use of the method prescribed in the preceding sentence.

.31 The relationship of depreciation to useful lives, and the nature of depreciation as an allocation process, not a valuation process, is noted in the definition offered in paragraph 56 of the AICPA's Accounting Terminology Bulletin no. 1, *Review and Resumé* (1953).

*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 of valuation. . . .

.32 Depreciation of a productive facility is described as follows in paragraph 5 of chapter 9C, Accounting Research Bulletin no. 43, *Emergency Facilities—Depreciation and Amortization*.

The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as

possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, 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 of valuation.

.33 Accounting Research Monograph no. 1, *Accounting for Depreciable Assets*,<sup>4</sup> suggests implementing criteria relative to useful life for depreciation purposes:

The estimate of "useful life" encompasses that span of time beginning after an asset is ready for use and begins to benefit the company significantly or when its ability to benefit the company begins to expire, and ending when the asset no longer benefits the company significantly or when its ability to benefit the company expires.

## ACCOUNTING STANDARDS DIVISION

### Accounting Standards Executive Committee

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Paul Rosenfield, <i>Director,</i> <i>Accounting Standards</i>	Thomas W. McRae, <i>Manager,</i> <i>Accounting Standards</i>
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<sup>4</sup> Charles W. Lambden, Dale L. Gerboth, and Thomas W. McRae, *Accounting for Depreciable Assets*, Accounting Research Monograph no. 1 (New York: AICPA, 1975), pp. 76-77.





**Section 10,190*****Statement of Position 78-4  
Application of the Deposit, Installment,  
and Recovery Methods in Accounting for  
Sales of Real Estate*****[A Proposed 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

June 30, 1978

Donald J. Kirk, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

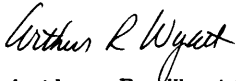
Dear Mr. Kirk:

The accompanying draft of statement of position, Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate, has been prepared on behalf of the accounting standards division by the AICPA's committee on real estate accounting and approved by the accounting standards executive committee.

The statement is an interpretation of the AICPA accounting guide, Accounting for Profit Recognition on Sales of Real Estate, issued in 1973. It presents the division's recommendations on the application of the deposit, installment, and cost recovery methods in accounting for sales of real estate. Diverse methods of application of those accounting methods have developed in practice, and the objective of the statement is to narrow the range of alternative practices.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely,

A handwritten signature in cursive script, reading "Arthur R. Wyatt".

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.

### APPLICATION OF THE DEPOSIT, INSTALLMENT, AND COST RECOVERY METHODS IN ACCOUNTING FOR SALES OF REAL ESTATE

.01 Questions have arisen about the application of the general principles and specific conclusions set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*, issued in 1973. The accounting standards division addressed some of those questions in Statement of Position 75-6 [section 10,100] (December 29, 1975). This statement presents recommendations as a result of questions concerning the application of the deposit, installment, and cost recovery methods in accounting for sales of real estate, which are discussed in paragraphs 34 to 37 of the accounting guide. Diverse methods of application of those accounting methods have developed in practice. The division believes that narrowing the range of alternative practices is desirable.

#### THE DEPOSIT METHOD

##### General

.02 Accounting under the deposit method is described in paragraph 35 of the accounting guide as follows:

The deposit method postpones recognizing a sale until a determination can be made as to whether a sale has occurred for accounting purposes. Pending recognition of the sale, the seller records no receivable but continues to show in his financial statements the property and related existing debt and discloses the status of the property. Cash received from the buyer is reported as a deposit on the contract except that portions of cash received that are designated by the contract as interest and are not subject to refund may appropriately offset carrying charges (property taxes and interest on existing debt) on the property.

.03 Except as indicated in the last sentence above, the seller's balance sheet should report all cash received from the buyer, including the initial down payment and subsequent collections of principal and interest, as a deposit (liability) on the contract. The seller's balance sheet should not report notes receivable arising from the transaction but should continue to report the property and any related mortgage debt assumed by the buyer and disclose that those items are subject to a sales contract. Nonrecourse debt assumed by the buyer should not be offset against the related property. Until the seller reports the sale, the buyer's principal payments on the mortgage debt assumed should be reported on the seller's balance sheet as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.

### **Forfeiture of Nonrefundable Deposits**

.04 When a buyer defaults or otherwise forfeits a nonrefundable deposit, the seller should credit the deposit account to income. The seller should evaluate whether the circumstances underlying the forfeiture indicate a decline in the value of the property for which an allowance for loss should be provided.

### **Depreciation**

.05 Since, under the deposit method, the seller accounts for the property as if it were still owned, the accounting standards division believes a legal sale should not cause the seller to stop recording depreciation. While some believe that depreciation may be charged to the deposit account to the extent that the deposits are not refundable, the division believes that practice is not consistent with the concepts underlying the deposit method and that depreciation should continue to be charged to expenses as a period cost.

### **Provisions for Losses**

.06 Under the deposit method, no sale is reported by the seller even if the terms of the transaction indicate that a loss has been incurred (for example, when the indicated sales value is less than the carrying amount of the property). The seller, however, should report the loss by a charge to income and as a valuation allowance against the property. The net carrying amount of the property, less the debt assumed by the buyer, should not exceed the sum of the recorded value of the con-

sideration received and the fair value of the unrecorded note receivable.

.07 If, at any time after the transaction, circumstances indicate that the buyer is likely to default and the property will revert to the seller, a provision for an additional loss may be required.

### **Sales Recognition**

.08 The seller does not report a sale and continues to use the deposit method until the conditions for recording a sale, as specified in the accounting guide, are met. Interest collected and included in the deposit account during the period before a sale is reported should be accounted for as additional sales proceeds at the time of recording the sale.<sup>1</sup>

## **THE INSTALLMENT METHOD**

### **General**

.09 When the substance of a real estate transaction indicates that a sale has occurred for accounting purposes, but collectibility of the total sales price cannot be estimated reasonably, the installment method may be appropriate unless circumstances such as those described in paragraphs 28 and 36 of the accounting guide indicate that the cost recovery method is appropriate. The installment method apportions the down payment and each subsequent collection of principal between cost recovered and profit recognized in the same ratio as cost and profit are presumed to constitute the sales value.

### **Debt Assumed by the Buyer**

.10 In some real estate sales transactions, the buyer assumes an existing mortgage loan. If the seller is contingently liable for the assumed debt, the seller has a risk of financial loss that is similar to the risk the seller would have if the debt had not been assumed and the seller's receivable from the buyer had been increased by the amount of the debt assumed by the buyer. If the seller is not contingently liable for debt assumed by the buyer (for example, if the buyer assumes a nonrecourse mortgage loan), some believe that, as cash payments are received by the seller, the portion of the profit recognized as earned under

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<sup>1</sup> See the section entitled "Cumulative Application of Tests When Recognition of Sale Is Delayed" in Statement of Position 75-6 [section 10,100], *Questions Concerning Profit Recognition on Sales of Real Estate*.

the installment method should be determined by the percentage of the cash received to the total cash to be received by the seller. The accounting standards division believes, however, that, for the purpose of applying the installment method, there should be no distinction between recourse and nonrecourse debt assumed by the buyer, because the seller may be motivated to honor the debt assumed by the buyer for various reasons, even though the seller is not contingently liable for the debt.

.11 Therefore, under the installment method, profit should be recognized on cash payments including principal payments by the buyer on the debt assumed and should be based on the percentage of total profit to total sales value (including the first mortgage debt assumed by the buyer). The following illustrates the calculation.

*Assumptions:*

Cash down payment	\$ 150,000
Second mortgage payable by buyer to seller (10-year amortization of principal plus interest)	350,000
Total cash to be received by seller	500,000
First mortgage assumed by buyer (20-year amortization of principal plus interest)	500,000
Total sales price and sales value	1,000,000
Cost	600,000
Total profit	\$ 400,000

The down payment is assumed to be inadequate for full profit recognition, and the installment method of accounting is assumed to be appropriate. It is also assumed that, subsequent to the down payment, the buyer pays \$25,000 of principal on the first mortgage and \$35,000 of principal on the second mortgage.

*Profit recognition attributable to down payment:*

Under the installment method, profit recognition attributable to the down payment is \$60,000, representing 40 percent ( $\$400,000 \div \$1,000,000$ ) of \$150,000.

*Profit recognition attributable to the principal payments on the first and second mortgages:*

Under the installment method, profit recognition attributable to the principal payments by the buyer on the first and second mortgages is \$24,000, representing 40 percent of \$60,000 (\$25,000 + \$35,000).

### **Financial Statement Presentation**

.12 The form of financial statement presentation under the installment method is illustrated in exhibit II, pages 31-33 of the AICPA industry accounting guide, *Accounting for Retail Land Sales* (1973). At the time of sale, the income statement should present the total sales value, from which the deferred gross profit should be deducted, and the total cost of the sale. Deferred gross profit should be presented on the balance sheet as a deduction from the related receivable. Deferred gross profit subsequently recognized as earned should be presented as a separate item of revenue on the income statement.

## **THE COST RECOVERY METHOD**

### **General**

.13 When the substance of a real estate transaction indicates that a sale has occurred for accounting purposes but that no profit should be recognized until costs are recovered because of the requirements of paragraphs 28 or 36 of the accounting guide, the cost recovery method must be used. In addition, the cost recovery method may be elected initially to report transactions for which the installment method is permitted.

.14 Under the cost recovery method, no profit is recognized until cash collections, including both principal and interest, and existing debt assumed by the buyer exceed the cost of the property sold.<sup>2</sup>

### **Financial Statement Presentation**

.15 At the time of sale, the income statement should present the total sales value, from which the deferred gross profit should

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<sup>2</sup> For an all-inclusive or "wrap-around" receivable held by the seller, interest collected may be recognized as income to the extent of, and as an appropriate offset to, interest expense on prior lien financing for which the seller remains responsible.

be deducted, and the total cost of the sale. Deferred gross profit should be presented on the balance sheet as a deduction from the related receivable. Principal collections should be used to reduce the related receivable. Interest collections on such receivable should be used to increase the deferred gross profit on the balance sheet. Deferred gross profit subsequently recognized as earned should be presented as a separate item of revenue on the income statement.

### **CHANGE FROM INSTALLMENT OR COST RECOVERY METHOD TO FULL ACCRUAL METHOD**

.16 When developments subsequent to the adoption of the cost recovery or installment method provide evidence that collectibility of the sale price is reasonably assured, a change should be made to the full accrual method. In the absence of other conditions requiring deferral of profit (such as the seller's continued involvement with the property sold or a decline in its value), the remaining deferred profit should be recognized in income at that time. For example, even though a nonrecourse debt assumed by the buyer having a prior lien on the property sold is not fully paid, a seller should ordinarily change from the installment or cost recovery method to the accrual method no later than the time the seller's receivable from the buyer is collected. Another circumstance that might ordinarily, but not necessarily, provide reasonable assurance that the remaining uncollected balance of the sales price is collectible would be collection, on a cumulative basis from the date the sale was first recorded on the installment or cost recovery basis, of the aggregate cumulative amounts contemplated by paragraphs 20, 21, and 25 of the accounting guide (for this purpose collections should be in cash or the other forms of payment specified in paragraphs 22 through 24 of the guide), with the buyer's continuing investment thereafter meeting the guide's requirements.

.17 The accounting standards division believes that a change from the cost recovery or installment method of reporting profit on a sale of real estate to the full accrual method as a result of changed conditions is not a change in accounting principles. However, if the change has a material effect on the seller's financial position or results of operations, the seller's financial statements should disclose the effect of, and the reason for, recognizing as income the profit on the uncollected portion of the sales value.



## TRANSITION

.18 The accounting standards division recommends the application of the provisions of this statement prospectively to transactions consummated in fiscal years beginning after June 30, 1978. Earlier application is encouraged for transactions consummated in fiscal years beginning before July 1, 1978, for which financial statements have not previously been issued.

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**Section 10,200****Statement of Position 78-5  
Accounting for Advance Refundings of  
Tax-Exempt Debt****[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

June 30, 1978

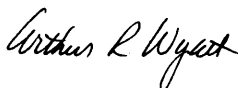
Donald J. Kirk, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting for Advance Refundings of Tax-Exempt Debt, was prepared by the accounting standards division and presents the division's recommendation on the accounting for advanced refundings of debt.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely,



Arthur R. Wyatt, Chairman  
Accounting Standards Division

cc: Securities and Exchange Commission

**➡ The next page is 18,423. ←**



## 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 FOR ADVANCE REFUNDINGS OF TAX-EXEMPT DEBT

.01 A refunding of debt is the replacement of old debt with new debt in order to obtain a perceived economic advantage. Although this perceived advantage may take various forms, it is frequently lower interest rates, a revised payment schedule, an extension of maturity dates, or the removal or modification of restrictions. An advance refunding is a refunding in which new debt is issued before the maturity or intended call date of the old debt, primarily for the purpose of replacing the old debt at a specified future date.

.02 This statement of position addresses accounting for advance refundings<sup>1</sup> of tax-exempt debt.<sup>2</sup> It is not intended to modify APB Opinion 26, *Early Extinguishment of Debt*, or FASB Statement 4, *Reporting Gains and Losses from Extinguishment of Debt*. The addendum to APB Opinion 2, "Accounting Principles for Regulated Industries," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process," and discusses the application of generally accepted accounting principles to regulated industries. This statement of position should be applied by entities for rate-

<sup>1</sup> Some advance refundings of debt involve corresponding changes in the provisions of existing leases. In this regard, see FASB Statement 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt: An Amendment of FASB Statement 13*.

<sup>2</sup> *Tax-exempt debt* as used here includes (1) tax-exempt debt and (2) debt (for example, a mortgage) and lease obligations that serve as collateral for tax-exempt debt.

making purposes on an individual-company-cost-of-service basis in accordance with the provisions of the addendum.

.03 Paragraphs .09 to .15 of this statement of position apply to accounting for advance refundings of tax-exempt debt including advance refundings entered into by nonprofit organizations other than state and local governmental units, that are reported in financial statements prepared in conformity with generally accepted accounting principles. Paragraphs .16 to .19 apply to state and local governmental units. Paragraph .20 sets forth appropriate disclosures, and paragraphs .21 to .23 discuss transition.

.04 The following circumstances illustrate an advance refunding of tax-exempt debt. Three years ago a corporation's capital improvements were financed by government-issued 9 percent tax-exempt industrial revenue bonds. The proceeds of the bonds were used to construct capital improvements for the corporation. The corporation's payments to the governmental unit issuer were structured in amount and timing to meet the debt service requirements of the bonds. During the past three years, interest rates in the tax-exempt bond market dropped from 9 percent to 6 percent, making it advantageous for the corporation, through the governmental unit, to replace the 9 percent debt. If the 9 percent debt is not callable, or if management does not intend to have the debt called until a future date, and the 6 percent debt is issued to replace the 9 percent issue, an advance refunding of tax-exempt debt has occurred.

.05 Advance refundings involving tax-exempt debt are subject to arbitrage rules under the Internal Revenue Code (section 103(c)) and related regulations that, in general, prohibit the yield realized from the investment of the proceeds of a new debt from exceeding the yield on the debt itself. Compliance with those rules is necessary for the interest on the debt to be exempt from federal income tax and, possibly, from state and local tax; compliance can be achieved by investing in U. S. Treasury obligations that yield a rate of interest not exceeding the yield on the new debt. The arbitrage rules do not prohibit investment in other securities so long as the yield is low enough to comply with those rules.

.06 As defined below, three methods are used to achieve advance refundings of tax-exempt debt: net advance refunding, full cash advance refunding, and crossover advance refunding.

.07 The accounting standards division believes guidance is needed concerning (a) the timing of income statement recognition of a gain or loss from an advance refunding, (b) when the refunded debt, the refunding debt, or both, along with the trust securities, should be included in the balance sheet, and (c) the method of income statement recognition for interest related to the debts and the trust securities.

### DEFINITIONS

.08 The following definitions apply to the terms used in this statement of position:

*Refunding debt* (sometimes referred to as “new debt”). Debt issued to provide funds to replace the refunded debt at a specified future date(s).

*Refunded debt* (sometimes referred to as “old debt”). Debt for which payment at a specified future date(s) has been provided by the issuance of refunding debt.

*Advance refunding*. A transaction in which refunding debt is issued to replace the refunded debt at a specified future date(s), with the proceeds placed in trust or otherwise restricted to replacing the refunded debt.

*Defeasance provision*. A provision in the refunded debt instrument that provides the terms by which the debt may be legally satisfied and the related lien released without the debt necessarily being retired.

*Defeasance*. Legal satisfaction of debt under the terms of a defeasance provision.

*Net advance refunding*. An advance refunding in which the proceeds from the new debt, additional cash deposits, if any, and the income earned on the related investments is sufficient to pay the interest and principal on the old debt and any call premium.

*Full cash advance refunding*. An advance refunding in which both revenue and special obligation bonds are sold and the net proceeds plus additional cash deposits, if any, are sufficient to pay the interest and principal on the old debt and any call premium.

*Special obligation bonds*. Debt that is issued concurrently with revenue bonds in a full cash advance refunding, normally at a lower interest rate and with a shorter maturity date than the revenue bonds. The proceeds from the revenue and special

obligation bonds are placed in trust, and the income realized from investment of the trust assets serves as collateral for, and will be used to service and retire, the special obligation bonds.

*Crossover advance refunding.* An advance refunding in which the proceeds from the new debt, additional cash deposits, if any, and the income earned on the related investments is sufficient to pay the principal and any call premium of the old debt and the interest on the new debt until the date of crossover. Until the date of crossover, the proceeds from the new debt serve as collateral for that debt. The old debt is serviced by the entity until the date of crossover, at which time the proceeds from the new debt are used to retire the old debt and the entity becomes obligated to service the new debt. In a crossover advance refunding, the old debt is never defeased at the time of advance refunding.

*Qualifying securities.* Direct U. S. Treasury obligations, securities backed by the U. S. government, or securities collateralized by U. S. government obligations.

## THE DIVISION'S CONCLUSIONS

### Entities Other Than State and Local Government Units

**.09** *Defeasance Transactions.* The accounting standards division believes that an advance refunding in which the refunded debt is defeased results in an early extinguishment of debt because the refunded debt is legally satisfied. The gain or loss from the advance refunding should be determined in accordance with the provisions of APB Opinion 26<sup>3</sup> and should be classified in accordance with FASB Statement 4. Since the old debt is legally satisfied, it is not a liability of the entity and should not be included in the balance sheet; only the new debt should be included. If special obligation bonds are issued as part of the advance refunding, they should not be presented in the balance sheet because they will be serviced from the earnings of the proceeds of the advance refunding and, therefore, represent an obligation of the trustee and not an obligation of the entity.

**.10** *Nondefeasance Transactions.* The division believes that advance refundings meeting all of the following criteria are completed transactions that should be accounted for in the same

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<sup>3</sup> See footnote 1.



manner as defeased transactions because the obligation for the refunded debt is satisfied in substance, even though in form the refunded debt is not defeased.

- The issuer is irrevocably committed to refund the old debt.
- The funds used to consummate the advance refunding are placed in an irrevocable trust with a reputable trustee for the purpose of satisfying the old debt at a specified future date(s).
- The funds used to consummate the advance refunding are invested in qualifying securities with maturities that approximate the debt service requirements of the trust.
- The invested funds used to consummate the advance refunding are not subject to lien for any purpose other than in connection with the advance refunding transaction.

.11 In an advance refunding transaction in which the refunded debt is not defeased and the criteria in paragraph .10 are not met, the division believes that the obligation for the refunded debt is not satisfied in substance, and there is no early extinguishment of debt. Consequently, no immediate gain or loss should be recognized on the transaction. However, if the retirement dates of the old debt have been established, the (1) call premium, (2) unamortized premium or discount, and (3) initial issue costs should be systematically recognized in the income statement over the remaining life of the old debt as an adjustment of the cost of borrowing related to the old debt.<sup>4</sup> In addition, the income earned on the funds used to consummate the advance refunding and the interest expense on both the old and new debts should be recognized in the income statement. The funds used to consummate the advance refunding should be reported as an asset, and both the old and new debts should be reported as liabilities. The assets and the liabilities should not be offset.

.12 If only a portion of the investments meet the criteria of paragraph .10, the accounting for the refunding will be partly in accordance with paragraph .10 and partly in accordance with paragraph .11. The portion of the refunded debt that would be accounted for in accordance with paragraph .10 should be based on the relationship of the cash to be provided from the investments that meet the criteria of paragraph .10 to the total cash necessary to accomplish the entire redemption of the old debt.

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<sup>4</sup> See footnote 1.

The balance of the refunded debt should be accounted for in accordance with paragraph .11.

**.13 *Crossovers.*** In a crossover, the old debt continues to be serviced by the entity until the date of the crossover. At the crossover date the old debt is retired and the entity becomes obligated to service the new debt. There is never defeasance in a crossover at the time of the advance refunding, and the accounting standards division believes that the transaction should not be treated as an in substance defeasance at that time either. Consequently, no immediate gain or loss should be recognized, and the accounting in paragraph .11 should be followed for crossover transactions.

**.14 *Third Party Reimbursement to Hospitals.*** If a third party is obligated to reimburse a hospital for the loss from an advance refunding, the hospital should report the loss net of the reimbursement. The portion of the reimbursement attributable to costs that cannot be claimed in the current year should be accounted for as a deferred charge and should be reduced in each subsequent year by the amount of reimbursement allowed. To the extent reimbursement is not reasonably assured, the loss should be recognized in the year incurred, and subsequent reimbursement should be recorded when received.

**.15 *Income Tax Accounting.*** Income tax allocation in accordance with APB Opinion 11, *Accounting for Income Taxes*, should be applied to a gain or loss as credited or charged to income in different periods for financial reporting and tax purposes.

### **State and Local Governmental Units**

**.16 *Enterprise Funds.*** In accounting for an advance refunding of debt that is an obligation of an enterprise fund, the accounting recommended for entities other than state and local governmental units should be followed.

**.17 *Other Than Enterprise Funds.*** In advance refundings of debt in which there is defeasance or in which the criteria of paragraph .10 are met, the old debt should be removed from either the long-term debt group of accounts or the balance sheet of the affected governmental fund and be replaced by the new debt. The proceeds of the new debt should be accounted for as revenue in either the debt service fund or the affected governmental fund. The issue costs and the amount transferred to the

trustee to retire the old debt should be accounted for as expenditures of the debt service fund or affected governmental fund. The amount transferred to the trustee should be shown in two parts: (1) retirement of principal and (2) gain or loss on advance refunding of debt.

**.18** If the advance refunding of debt does not result in defeasance or meet the criteria in paragraph .10, the governmental unit is responsible for the new debt and remains responsible for the old debt until it is retired. Therefore, both debts should be presented in either the long-term debt group of accounts or the balance sheet of the affected governmental fund. The gross proceeds of the new debt should be recorded as revenue of either the debt service fund or other affected governmental fund; the issue costs should be recorded as an expenditure of the debt service or other affected governmental fund with the resultant net increase to a restricted fund balance. If the retirement dates of the old debt have been established, the (1) call premium, (2) unamortized premium or discount, and (3) initial issue cost should be systematically recognized in the statement of revenues and expenditures over the remaining life of the old debt as an adjustment of the cost of borrowing related to the old debt. The funds used to consummate the advance refunding should be recorded as an asset. Income earned on the funds used to consummate the advance refunding should be recorded as revenue and interest expense on both debts recorded as expenditures.

**.19** In a crossover, the old debt continues to be serviced by the governmental unit until the date of the crossover. At the crossover date the old debt is retired, and the governmental unit becomes obligated to service the new debt. There is never defeasance in a crossover at the time of the advance refunding, and the accounting standards division believes that the transaction should not be treated as an in substance defeasance at that time either. Consequently, no immediate gain or loss should be recognized and the accounting in paragraph .18 should be followed for crossover transactions in a governmental unit.

### DISCLOSURE

**.20** Financial statements for the period in which an advance refunding occurs should include a general description of the advance refunding, including identification of the debts involved, along with disclosures required by FASB Statement 4. A general description of the advance refunding transaction, in-

cluding identification of the debts involved, should be disclosed in the financial statements for each subsequent period until the old debt and any special obligation bonds are retired.

### TRANSITION

**.21** This statement of position should be applied to advance refundings of debt consummated on or after July 1, 1978.

**.22** If an advance refunding of debt involves a lease, this statement of position shall not be adopted retroactively for previously published annual financial statements unless it is being applied in the same manner as and concurrently with the application of FASB Statement 22.

**.23** If an advance refunding of debt does not involve a lease, earlier application of the provisions of this statement of position is encouraged for advance refundings of debt consummated before July 1, 1978, but it should not be retroactively applied to advance refundings of debt consummated during fiscal years for which annual financial statements have previously been issued.

### APPENDIX

**.24**

#### Illustration 1

#### Calculation of Gain or Loss in a Net Advance Refunding of Tax-Exempt Debt With Defeasance

In a net advance refunding of tax-exempt debt, the proceeds from the new debt, additional cash deposits, if any, and the income earned on the related investments are sufficient to pay the interest, principal, and call premium on the old debt. After the advance refunding, the old debt is serviced by the investments in trust and the new debt is serviced by the entity.

#### Assumptions

##### Old debt

Principal outstanding	\$50,000,000
Interest rate	9.5%
Earliest call date	5 years
Call premium	3%
Unamortized issue costs	\$ 1,300,000
Unamortized discount	\$ 700,000

## New debt

Principal	\$60,000,000
Average coupon interest rate	5.372%
True interest cost—yield	6%
Issue costs	\$ 1,507,479
Issue price	100
Period outstanding	30 years
Yield on direct U. S. Treasury obligations	6%

**Calculation of New Debt**

New debt and proceeds from new debt required to provide for payment of old debt

	Present value of future cash requirements at 5.372%	Earnings on direct U. S. Treasury obligations	Total future cash requirements
Call premium—			
old debt	\$ 1,154,689	\$ 345,311	\$ 1,500,000
Principal—			
old debt	38,489,643	11,510,357	50,000,000
Interest—			
old debt	20,355,668	3,394,332	23,750,000
Gross proceeds of new debt	60,000,000	15,250,000	75,250,000
Debt issue costs	(1,507,479)	1,507,479	
Net proceeds to be invested	\$58,492,521	\$16,757,479	\$75,250,000

After payment of the new debt issue costs, the proceeds from the new debt total \$58,492,521. As permitted by the IRS arbitrage regulations, the direct U. S. Treasury obligations acquired with the proceeds of the new debt will yield 6 percent (to earn \$16,757,479). Proposed IRS arbitrage regulations issued May 3, 1978, will exclude consideration of administrative cost in determining yield with respect to obligations issued after September 1, 1978.

Proceeds from the new debt will be sufficient to service the old debt as follows:

Present value of call premium (discounted at 6%)	\$ 1,120,887
Present value of interest requirements (discounted at 6%)	20,008,728
Present value of principal (discounted at 6%)	37,362,906
<hr/>	
Proceeds from the new debt invested in direct U. S. Treasury obligations	58,492,521
Issue costs	1,507,479
<hr/>	
New debt	<u>\$60,000,000</u>
<hr/>	
<b>Loss on Advance Refunding</b>	
New debt	\$60,000,000
Issuance costs to be deferred and amortized over the life of new debt	(1,507,479)
<hr/>	
	\$58,492,521
Carrying amount of old debt	
Principal	\$50,000,000
Unamortized discount	(700,000)
Unamortized issue costs	(1,300,000)
<hr/>	
	48,000,000
<hr/>	
Loss on advance refunding	<u>\$10,492,521</u>
<hr/>	

**Entries<sup>1</sup>****Advance refunding date**

Loss on advance refunding	10,492,521	
Deferred issue costs	1,507,479	
Old debt	50,000,000	
Unamortized discount—old debt		700,000
Unamortized issue costs—old debt		1,300,000
New debt		60,000,000

**To record advance refunding of debt****First year**

Interest expense	3,223,200	
Debt issue costs	50,250	
Deferred issue costs		50,250
Cash		3,223,200
<b>To record amortization of debt issue costs and interest expense on new debt</b>		

<sup>1</sup>These illustrative entries, as well as others that follow in this Appendix, exclude related income tax effects.

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## Illustration 2

**Calculation of Gain or Loss  
in Full Cash Advance Refunding of  
Tax-Exempt Debt with Defeasance**

In a full cash advance refunding of tax-exempt debt, the principal amount of the revenue bonds is calculated in the same manner as in net advance refunding. Special obligation bonds are issued to provide additional funds, which, together with the proceeds from the revenue bonds, and additional cash deposits, if any, will be sufficient to pay the interest, principal, and call premium on the old debt. After the advance refunding occurs, the old debt is serviced by the investments in trust and the revenue bonds are serviced by the entity. The special obligation bonds are serviced by the income earned on the investments in trust.

**Assumptions**

## Old debt

Principal outstanding	\$50,000,000
Interest rate	9.5%
Earliest call date	5 years
Call premium	3%
Unamortized issue costs	\$ 1,300,000
Unamortized discount	\$ 700,000

## Revenue bonds

Principal	\$60,000,000
Average coupon interest rate	5.372%
True interest cost—yield	6%
Issue costs	\$ 1,507,479
Issue price	100
Period outstanding	30 years
Yield on direct U. S. Treasury obligations <sup>2</sup>	6%

## Special obligation bonds

Principal	\$17,150,479
Average coupon interest rate	3%
True interest cost—yield	3.5394%
Issue costs	\$ 393,000
Issue price	100
Period outstanding	5 years
Yield on direct U. S. Treasury obligations <sup>2</sup>	3.5394%

---

<sup>2</sup> IRS arbitrage regulations require that a separate yield must be calculated on the investments acquired with the proceeds of each issue.

**Calculation of New Debt**

Total future cash requirements of old debt	
Principal—old debt	\$50,000,000
Call premium—old debt	1,500,000
Interest—old debt	23,750,000
<hr/>	
Total future cash requirements of old debt	<u>\$75,250,000</u>

## Proceeds from sale of new debt

	Revenue bonds	Special obligation bonds	Total
<hr/>			
Gross proceeds from sale of debt	\$60,000,000	\$17,150,479	\$77,150,479
Debt issue costs	(1,507,479)	(393,000)	(1,900,479)
<hr/>			
Net proceeds to be invested	<u>\$58,492,521</u>	<u>\$16,757,479</u>	<u>\$75,250,000</u>

After payment of debt issue costs, the proceeds from both issues total \$75,250,000, which is sufficient to service the old debt until it is called. As permitted by the IRS arbitrage regulations, the direct U. S. Treasury obligations acquired with the proceeds of the revenue bonds and the special obligation bonds will yield 6 percent and 3.53994 percent respectively. Proposed IRS arbitrage regulations issued May 3, 1978, will exclude consideration of administrative cost in determining yield on obligations issued after September 1, 1978. The earnings on these investments will be sufficient to service the special obligation bonds as follows:

## Earnings on direct U. S. Treasury obligations used to service special obligation bonds

Earnings on proceeds of revenue bonds at 6%	\$16,757,479
Earnings on proceeds of special obligation bonds at 3.5394%	2,965,570
<hr/>	
	<u>\$19,723,049</u>

## Debt service requirements of special obligation bonds

Principal	\$17,150,479
Interest at 3%	2,572,570
<hr/>	
	<u>\$19,723,049</u>



**Loss on Advance Refunding <sup>3</sup>**

Revenue bonds		\$60,000,000
Issuance costs to be deferred and amortized over the life of the revenue bonds		(1,507,479)
		<hr/>
		\$58,492,521
Carrying amount of old debt		
Principal	\$50,000,000	
Unamortized discount	(700,000)	
Unamortized issue costs	(1,300,000)	48,000,000
		<hr/>
Loss on advance refunding		<u>\$10,492,521</u>

**Entries****Advance refunding date**

Loss on advance refunding	10,492,521	
Deferred issue costs	1,507,479	
Old debt	50,000,000	
Unamortized discount— old debt		700,000
Unamortized issue costs— old debt		1,300,000
New debt		60,000,000

**To record advance refunding of debt****First year**

Interest expense	3,223,200	
Debt issue costs	50,250	
Deferred issue costs		50,250
Cash		3,223,200

**To record amortization of debt issue costs and interest expense on new debt**

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**Illustration 3****Calculation of Gain or Loss****in a Net Advance Refunding of Tax-Exempt****Debt When Only a Portion of the Trust****Investments Meet the Criteria of Paragraph .10**

In a net advance refunding of tax-exempt debt, the proceeds from the new debt, additional cash deposits, if any, and the in-

<sup>3</sup> The special obligation bonds are not included in the calculation of the loss on advance refunding or in the balance sheet because they will be serviced from the earnings on the proceeds from the advance refunding and do not constitute an obligation of the entity.

come earned on the related investments are sufficient to pay the interest, principal, and call premium on the old debt. After the advance refunding, the old debt is serviced by the investments in trust, and the new debt is serviced by the entity.

If only a portion of the investments meet the criteria of paragraph .10, the accounting for the refunding will be in part in accordance with paragraph .10 and in part in accordance with paragraph .11. The portion of the refunded debt that would be accounted for in accordance with paragraph .10 would be based on the relationship of the cash to be provided from the investments that meet the criteria of paragraph .10 to the total cash necessary to accomplish the entire redemption of the old debt. The balance of the refunded debt would be accounted for in accordance with paragraph .11.

### Assumptions

#### Old debt

Principal outstanding	\$70,000,000
Interest rate	9.5%
Earliest call date	5 years
Call premium	3%
Unamortized issue costs	\$ 1,820,000
Unamortized discount	\$ 980,000

#### New debt (investment of proceeds will meet criteria of paragraph .10)

Principal	\$60,000,000
Average coupon interest rate	5.372%
True interest cost-yield	6%
Issue costs	\$ 1,507,479
Issue price	100
Period outstanding	30 years
Yield on direct U. S. Treasury obligations	6%

#### Additional cash provided by entity (investment of cash will not meet criteria of paragraph .10)

Cash invested in certificates of deposit	\$21,606,000
Average interest rate of certificates of deposit	8%

**Calculation of New Debt**

New debt and proceeds from new debt required to complete the advance refunding

Total future cash requirements

Call premium—old debt	\$ 2,100,000
Principal—old debt	70,000,000
Interest—old debt	33,250,000
Total future cash requirements	<u>105,350,000</u>

Total future cash to be provided from certificates of deposit <sup>4</sup>

Cash invested	\$21,606,000	
Interest to be earned	<u>8,494,000</u>	<u>30,100,000</u>

Total future cash to be provided from proceeds of new debt \$ 75,250,000

New debt—present value of future cash to be provided from proceeds of new debt at

5.372% \$ 60,000,000

Debt issue costs (1,507,479)

Net proceeds of new debt to be invested \$ 58,492,521

After payment of the new debt issue costs, the proceeds from the new debt total \$58,492,521. As permitted by the IRS arbitrage regulations, the direct U. S. Treasury obligations acquired with the proceeds of the new debt will yield 6 percent rather than 5.372 percent, to earn the additional \$1,507,479. Proposed IRS arbitrage regulations issued May 3, 1978, will exclude consideration of administrative cost in determining yield on obligations issued after September 1, 1978.

**Loss on Advance Refunding**

The portion of the refunded debt that would be accounted for in accordance with paragraph .10 would be based on the relationship of cash to be provided from the investments that meet the criteria of paragraph .10 to the total cash necessary to accomplish the entire redemption of the old debt.

<sup>4</sup> Amounts will vary depending on the specific circumstances of the refunding.

		Ratio of cash to be provided to total cash	Portion of refunded debt
	Cash to be provided		
Investments meeting paragraph .10 criteria	\$ 75,250,000	71.429%	\$50,000,000
Investments not meeting criteria	30,100,000	28.571%	20,000,000
	<u>\$105,350,000</u>	<u>100.000%</u>	<u>\$70,000,000</u>
New debt			\$60,000,000
Issuance costs to be deferred and amortized over the life of the new debt			(1,507,479)
			<u>58,492,521</u>
Carrying amount of portion of old debt to be accounted for in accordance with paragraph .10			
Principal	\$50,000,000		
Unamortized discount	(700,000)		
Unamortized issue costs	(1,300,000)		48,000,000
Loss on advance refunding			<u>\$10,492,521</u>

**Entries**

## Advance refunding date

Loss on advance refunding	10,492,521	
Deferred issue costs	1,507,479	
Funds held in trust—CDs	21,606,000	
Old debt	50,000,000	
Unamortized discount—old debt		700,000
Unamortized issue costs—old debt		1,300,000
New debt		60,000,000
Cash		21,606,000

To record advance refunding of debt

## First year

Interest expense	3,223,200	
Debt issue costs	50,250	
Deferred issue costs—new debt		50,250
Cash		3,223,200

To record amortization of debt issue costs and interest expense on new debt		
Cash	1,728,480	
Interest income from funds held in trust		1,728,480
To record interest income from certificates of deposits held in trust.		
Interest expense	1,900,000	
Discount	56,000	
Debt issue costs	104,000	
Unamortized discount—old debt		56,000
Deferred issue costs—old debt		104,000
Cash		1,900,000
To record amortization of discount and debt issue costs and interest expense on \$20,000,000 of old debt		
Call premium expense	120,000	
Accrued call premium payable		120,000
To systematically accrue call premium on \$20,000,000 of old debt		

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The division gratefully acknowledges the contribution made to the development of this statement of position by Michael J. Walters.

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## OCR Section 20,000

# VOLUNTARY QUALITY CONTROL REVIEW PROGRAM FOR CPA FIRMS

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## NOTICE TO USERS

The quality control standards committee intends that this checklist be used as a tool by trained personnel in reviewing working papers and reports of audit engagements in connection with technical standards reviews provided under the AICPA voluntary quality control review program for CPA firms. Such reviews are confidential consulting reviews that result in an oral report by the reviewers. The checklist is also available, upon request, for purchase by AICPA members subject to their recognition of the following:

1. This checklist is a "tool" and in no way represents official positions or pronouncements of the AICPA.
2. It is intended as a guide rather than a fixed program, and in application it will probably require some modification depending on the size and nature of the engagements being reviewed.
3. Pronouncements issued after preparation of this checklist will also require that it be modified accordingly.
4. The checklist should be used by persons having expert knowledge of generally accepted accounting principles and auditing standards and preferably by someone who has had experience in reviewing reports and working papers. An untrained person may find the checklist confusing and reach results and conclusions that may be meaningless or perhaps misleading.
5. The checklist was developed for use in reviewing engagements of general "for-profit" companies and probably will require extensive modification if applied to engagements of "not-for-profit" organizations and companies in specialized industries.

References to AICPA and FASB publications have been updated through April 28, 1978 (through SAS No. 22 and FASB Statement No. 21).

The committee welcomes and appreciates comments and suggestions about the checklist and its use. Comments by qualified users can be of valuable assistance in updating the checklist and administering the program. Your comments and suggestions should be sent to the American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, New York 10036. Attention: quality control review division

➡ *The next page is 31,051.* ←





**QCR Section 20,100*****Technical Standards Review—Checklist  
Questionnaire for Audit Engagements***

April 1978

**PART ONE****INTRODUCTION**

.01 This questionnaire is not intended to be a complete test of the sufficiency of an auditor's report, the financial statements, or the supporting workpapers. Rather, it is intended as a working tool for a qualified reviewer in applying his expertise in evaluating the methods and procedures followed by a firm of independent accountants and encouraging the firm to observe reporting practices that are generally accepted by the profession.

.02 A separate questionnaire should be used for each set of engagement papers reviewed.

.03 Questions are worded so that "no" answers ordinarily indicate unsatisfactory conditions. A "no" answer should be supplemented in the Remarks section with reasons for the response.

.04 After completing the review, comments pertaining to unsatisfactory conditions and the reviewer's recommendations should be summarized in the "Comments for Discussion" section to facilitate discussion of findings and conclusions with the participant.

.05 References in the checklist for Statements on Auditing Standards are to the individual Statement Numbers 1 to 22. Statement Numbers 1 through 21 appear in the Codification of Statements on Auditing Standards Numbers 1 through 21 (January, 1978), and in Volume 1, AICPA Professional Standards, as follows:

SAS No.		Section No.
2	Reports on Audited Financial Statements	509
3	The Effects of EDP on the Auditor's Study and Evaluation of Internal Control	321
4	Quality Control Considerations for a Firm of Independent Auditors	160

SAS No.		Section No.
5	The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report	411
6	Related Party Transactions	335
7	Communications Between Predecessor and Successor Auditors	315
8	Other Information in Documents Containing Audited Financial Statements	550
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.06

TITLE SHEET

CPA Firm Reviewed:

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Office (if more than one):

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Name of Audit Engagement Reviewed:

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Date of Financial Statements: (NOTE)

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Date of Report:

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Date Review Performed:

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Review Team:

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NOTE

The checklist was prepared with the assumption that the audit engagement under review covers a full year. Therefore, no questions were included as to conformity with portions of APB Opinion No. 28--Interim Financial Reporting, that do not apply to year-end financial statements

To determine the applicability of all cross-referenced pronouncements, their effective dates should be considered.

➡ The next page is 31,055. ←



PART TWO  
AUDITOR'S REPORT

.07

NOTE:

SAS=Statement on Auditing Standards

To determine the applicability of cross-referenced pronouncements, their effective dates should be considered.

1. If the auditor's report is unqualified, does its wording conform to the standard report? (SAS No. 2, paragraph 7 and SAS No. 15, paragraph 3)

2. If required by the circumstances, does the auditor's report depart from the standard report? (SAS No. 2, paragraph 9)

3. Do the circumstances presented in the working papers support the auditor's report?

4. If necessary, does the auditor's report include recognition of the following:

a. Part of the examination made by other independent auditors? (SAS No. 1, section 543 and SAS No. 2, paragraph 14)

b. Effect on financial statements of a departure from generally accepted accounting principles? (SAS No. 2, paragraphs 9 and 15-19, and SAS No. 17, paragraph 15)

YES NO N/A REMARKS


## A. AUDITOR'S REPORT (Continued)

REMARKS

YES NO N/A

- |    |  |  |  |  |  |
|----|--|--|--|--|--|
| c. | Reporting requirements for departure from a "Promulgated Accounting Principle?" (SAS No. 2, paragraphs 9, 18 and 19)   |  |  |  |  |
| d. | Emphasis of a matter in a middle paragraph regarding the financial statements? (SAS No. 2, paragraphs 9 and 27)  |  |  |  |  |
| e. | Accounting principles not consistently applied? (SAS No. 1, sections 420 and 546; and SAS No. 2, paragraphs 9, 20, and 38, see SAS No. 1, sections 420.20 & .21 for specific language of report.                 |  |  |  |  |
| f. | Uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditors' report? (SAS No. 2, paragraphs 21-26 and 45, and SAS No. 17, paragraph 16) |  |  |  |  |
| g. | Comparative financial statements with differing opinions? (SAS No. 15, paragraph 5)  |  |  |  |  |
| h. | Updating of a previously issued opinion? (SAS No. 15, paragraphs 6-7)  |  |  |  |  |

A. AUDITOR'S REPORT (Continued)

	AUDITOR'S REPORT			REMARKS
	YES	NO	N/A	
i. Report of a predecessor auditor? (SAS No. 7 and SAS No. 15, paragraphs 8-12)				
j. Inclusion of unaudited financial statements? (SAS No. 15, paragraphs 13-15)				
k. Regulated companies? (SAS No. 1, section 544.02 and SAS No. 14)				
l. Negative assurances? (If a letter to an underwriter, see SAS No. 1, sections 518 and 630)				
m. Misstatement or omission of segment information if required? (SAS No. 21, paragraphs 8-16; FASB No. 21, paragraphs 12-16)				
5. Are the following appropriate:				
a. Date (or need for multiple dates) of report? (SAS No. 1, section 530)				
b. Salutation used? (SAS No. 2, paragraph 8)				

## A. AUDITOR'S REPORT (Continued)

	REMARKS		
	YES	NO	N/A
6. If supplemental data accompanies the basic financial statements, (SAS No. 1, section 610) does the auditors' report contain a clear-cut indication of the character of the examination and the degree of responsibility he is taking with respect to such data? (SAS No. 1, section 610)			
7. If a short and long-form report is presented (issued) is the long-form presentation consistent with the short-form? (SAS No. 1, section 610.04)			
8. For special reports, have the provisions of SAS No. 14 been complied with for:			
a. Statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles? (SAS No. 14, paragraphs 2-8)			
b. Specified elements, accounts or items of a financial statement? (SAS No. 14, paragraphs 9-17)			
c. Compliance with aspects of agreements or regulatory requirements relating to audited			



A. AUDITOR'S REPORT (Continued)

	REMARKS		
	YES	NO	N/A
financial statements? (SAS No. 14, paragraphs 18-19)			
d. Financial information presented in prescribed formats that require a prescribed form of auditor's report? (SAS No. 14, paragraphs 20-21)			
e. Segment information if applicable? (SAS No. 14, paragraphs 10-13; SAS No. 21, paragraphs 17-18; FASB No. 21, paragraphs 12-16)			
9. If a qualified opinion, adverse opinion or disclaimer was issued, (SAS No. 2, paragraphs 15, 29-47):			
a. Were all the substantive reasons for the opinion or disclaimer adequately disclosed?			
b. Was the reporting language clear and appropriate?			
10. Is the firm aware that piecemeal opinions are prohibited? (SAS No. 2, paragraph 48. For effective dates, see SAS No. 2, paragraph 50)			

A. AUDITOR'S REPORT (Continued)

REMARKS		
YES	NO	N/A

11. If prior period statements used for comparative purposes were either unaudited or not examined by the reporting auditor (SAS No. 2, paragraphs 10-12 and SAS No. 15, paragraphs 8-15) are:  

a. Appropriate disclosures made in the statements?  
  
OR  
b. In the auditor's report?
12. If financial statements of one or more prior periods are presented with those of the current year, does the language of the auditor's report appropriately cover the statements presented? (SAS No. 15, paragraphs 2-7)
13. If the financial statements include representations to the effect that a related party transaction was consummated on terms no less favorable than those that would have been

A. AUDITOR'S REPORT (Continued)

YES	NO	N/A	REMARKS

obtained if the transaction had been with an unrelated party, and the auditor—

a. Was unable to reach a conclusion as to the propriety thereof, has the opinion been qualified or disclaimed? (SAS No. 6, paragraph 18 and SAS No. 2, paragraphs 10-12)

b. Believes that the representation is misleading, has the opinion been qualified or expressed as adverse depending upon materiality? (SAS No. 6, paragraph 18, SAS No. 2, paragraphs 15 and 16 and SAS No. 19, paragraph 3)

14. If the work of a specialist was used, was the effect of the specialist's work on the auditor's report considered in accordance with SAS No. 11, paragraphs 9-12?

15. If the financial statements include a footnote containing interim financial information, has the auditor's report been expanded, if required, in accordance with SAS No. 13?

A. AUDITOR'S REPORT (Continued)

REMARKS		
YES	NO	N/A

16. If unaudited replacement cost information is presented:

a. Is the language of the report appropriate? (SAS No. 18, paragraphs 7-9)

b. Does the language of the report reflect findings of the underlying procedures performed? (SAS No. 18, paragraphs 4-6 and 12)
17. Other remarks?

.08

**NOTE:**

ARB=Accounting Research Bulletin

APB=Accounting Principles Board Opinion

FASB=Statement of the Financial Accounting Standards Board

SAS=Statement on Auditing Standards

**B. FINANCIAL STATEMENTS AND FOOTNOTES**

To determine the applicability of cross-referenced pronouncements their effective dates should be considered.

YES NO N/A REMARKS

1.	Are comparative financial statements presented? (ARB 43, chapter 2A)				
2.	Is restricted cash appropriately segregated from other cash items and properly classified? (ARB 43, chapter 3A, paragraph 6)				
3.	Are the current portions of various assets and liabilities classified as current items? (ARB 43, chapter 3A, paragraphs 4-8 and FASB No. 6, paragraph 15)				
4.	Are items not expected to be realized during the current operating cycle included under non-current asset captions? (ARB 43, chapter 3A, paragraphs 5 and 6)				
5.	Is there adequate disclosure of the separate classes of inventory (e.g. raw materials work in process, finished goods, etc.) if material? (ARB 43, chapter 3A, paragraphs 4 and 9, chapter 4, statement 1)				

## B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

REMARKS

YES NO N/A


6. Are inventories stated at the lower of cost as defined, or market? (If "no" does the practice of the industry allow other methods?) (ARB 43, chapter 4, statements 3 and 7)

7. Are short-term obligations that are both intended to be refinanced on a long-term basis, and accompanied by evidence of ability to consummate the refinancing, excluded from current liabilities and accompanied by adequate footnote disclosure? (FASB No. 6, paragraphs 10-15)

8. Is a statement of changes in financial position presented for each period for which an income statement is presented? (APB No. 19, paragraph 7)

9. Is a summary description of the significant accounting policies presented? (APB No. 22, paragraphs 8-15)

10. Do all the statements presented include a general reference such as "the accompanying notes are an integral part of these financial statements," and are the notes

(Continued)

B. FINANCIAL STATEMENTS AND FOOTNOTES

REMARKS

N/A

NO

YES

numbered and referenced from the statements or appropriately captioned? (APB Statement No. 4, chapter 2, paragraph 10)

Does there appear to be adequate disclosure by footnote or otherwise with respect to:

a. Marketable securities? (ARB 43, chapter 3A, paragraph 9 and FASB No. 12, paragraphs 12, 13, 16, 17, 19 and 20)

b. Notes and accounts receivable due from officers, employees, or affiliated companies? (ARB 43, chapter 1A, paragraph 5 and SAS No. 6, paragraphs 2, 16 and 17)

c. Allowance for losses on receivables? (APB No. 12, paragraph 3)

d. Accrued liabilities?

e. The method of determining inventory costs (FIFO, LIFO, average, etc.) and recognizing any diminished utility (cost or market, whichever is lower)? (ARB 43, chapter 4, statements 3-9 and SAS No. 1, section 430.02).

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
f. Investments? (APB No. 18, paragraph 20 and FASB No. 12, paragraphs 6 and 18)				
g. Intangible assets and their amortization? (APB No. 17, paragraphs 24-31)				
h. Principles of consolidation? (ARB 51, paragraph 5)				
i. Parents' equity in net assets and net income of unconsolidated subsidiaries and affiliates? (ARB 51, paragraph 19)				
j. Translation of foreign currency transactions and foreign currency financial statements? (ARB 43, chapter 12, paragraphs 6, 8 and 9; FASB No. 8, paragraphs 32-34)				
k. Changes in accounting principles? (SAS No. 1, sections 546.01-546.11 and 546.17; APB No. 20, paragraphs 17-30; FASB No. 3, paragraphs 9-14)				
l. Business combinations accounted for as poolings of interest? (APB No. 16, paragraphs 63-65; SAS No. 1, sections 546.12 and 546.13; SAS No. 15, paragraph 12)				



B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
m. Business combinations accounted for as purchases? (APB No. 16, paragraphs 95-96)				
n. Long-term construction-type contracts? (ARB 45, paragraph 15; and APB No. 22, paragraph 13)				
o. Bond indenture and loan agreement provisions? (APB Statement No. 4, paragraph 199 R-9A; and FASB No. 6, paragraph 15)				
p. Unusual accruals and allowances? (FASB Nos. 5 and 11)				
q. Changes in capital shares and in components of stockholders' equity? (APB No. 12, paragraph 10; FASB No. 6, paragraph 15)				
r. Liquidation preference of preferred stock in the equity section of the balance sheet? (APB No. 10, paragraphs 10 and 11; APB 15, paragraph 19)				
s. Number of shares of various classes of stock authorized, issued and outstanding, and the pertinent rights and privileges of the various securities outstanding? (APB No. 10, paragraphs 10 and 11; APB No. 15, paragraph 19)				

## B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

REMARKS

YES NO N/A

- |    |   |  |  |  |  |
|----|---|--|--|--|--|
| t. | Option agreements? (ARB 43, chapter 13B, paragraph 15; APB No. 25, paragraph 19) Is accounting proper? (APB No. 25, paragraphs 10-18) |  |  |  |  |
| u. | Restrictions on retained earnings? (APB No. 6, paragraph 13; FASB No. 5, paragraph 15)  |  |  |  |  |
| v. | Dating of retained earnings after a quasi-reorganization? (ARB 43, chapter 7A, paragraph 10; ARB 46)                                  |  |  |  |  |
| w. | Pension plans? (APB No. 8, paragraph 46; FASB interpretation No. 3, paragraphs 4 and 5)   |  |  |  |  |
| x. | Leases (including capital, operating, sales, direct financing and leveraged leases)? (FASB No. 13, paragraphs 16, 23, 47, and 48)     |  |  |  |  |
| y. | Assets pledged or assigned? (FASB No. 5, paragraphs 18 and 19; SAS No. 1, section 430.02)   |  |  |  |  |

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
z. Commitments for material amounts of new construction or equipment? (FASB No. 5, paragraphs 18 and 19 and ARB 45, paragraph 16)				
aa. Contingencies? (FASB No. 5, paragraphs 9-13)				
bb. Depreciable assets (property, plant and equipment, etc.) and depreciation:				
(i) Depreciation expense for each period? (APB No. 12, paragraph 5a)				
(ii) Balances of major classes of depreciable assets by nature of function? (APB No. 12, paragraph 5b)				
(iii) Accumulated depreciation, either by major classes of assets or in total? (APB No. 12, paragraph 5c)				
(iv) The method or methods used in computing depreciation with respect to major classes of depreciable assets? (APB No. 12, paragraph 5d)				
(v) Investment credit, method followed and amounts involved when material? (APB No. 4)				

## B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
cc. Deferred income taxes? (APB No. 11, paragraphs 57-62)				
dd. Carry forward losses for income taxes or other credits available? (APB No. 11, paragraphs 63(a) and 63(b))				
ee. Reasons for difference of tax expense shown from customary relationship between income before taxes and tax expense? (APB No. 11, paragraph 63(c); APB No. 23, paragraph 14)				
ff. When renegotiation refunds under government contracts cannot be accurately estimated? (ARB 43, chapter 11B, paragraphs 4 and 5)				
gg. Prior period adjustment? (APB No. 9, paragraph 26; APB No. 20, paragraphs 27, 28, 36 and 37; FASB No. 16, paragraphs 10-17)				
hh. Earnings per share on the face of the income statement, accompanied by an explanatory schedule or note that includes the basis of calculations? (APB No. 15, paragraphs 12-18 and 20-23)				

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
11. Subsequent events? (SAS No. 1, sections 560.01 to 560.12 and 561.04 to 561.09 and FASB No. 5, paragraph 11)				
12. Is interest on receivables and payables (including premium and discount) presented properly? (APB No. 21, paragraph 16)				
13. If there are any investments in common stock accounted for by the equity method, are the income taxes on the investor's share of the investee's earnings reflected properly? (APB No. 24, paragraphs 7-10)				
14. If there are nonmonetary transactions of either a nonreciprocal or exchange nature, are they recorded in accordance with APB No. 29?				
15. If there is an early extinguishment of debt, is the accounting proper and are all necessary disclosures made? (APB No. 26, paragraphs 18-21; FASB No. 4, paragraphs 8-12)				
16. If a segment of the business is sold, abandoned, spun off, or otherwise disposed of (or, although still operating, is the subject of a formal plan for disposal):				

## B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES NO N/A			REMARKS
a. Are discontinued operations and earnings per share correctly reflected in the income statement? (APB No. 30, paragraphs 8, 9 and 12)				
b. Are disclosures made in notes describing the identity of the segment sold, the date and manner of disposal, the assets and liabilities remaining, if any, and the income or loss from operations from measurement date to the date of the balance sheet? (APB No. 30, paragraph 18)				
17. Are extraordinary items properly disclosed and classified and did they meet the criteria for consideration as extraordinary items? (APB No. 9, paragraph 17; APB No. 30, paragraphs 10, 11, 19 through 25; FASB No. 16, paragraph 16c)				
18. Are material events or transactions that are either unusual in nature, or of infrequent occurrence but not both (and therefore not meeting both criteria for classification as an extraordinary item) reported as a separate component of income from continuing operations? (APB No. 30, paragraph 26)				

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
19. Are related party transactions adequately disclosed in the financial statements and accompanying notes? (SAS No. 6, paragraphs 16 and 17)				
20. Are research and development costs charged to expense when incurred, and appropriately disclosed? (FASB No. 2, paragraphs 12-16)				
21. Are required disclosures made of aggregate exchange gains or losses and effects of rate changes on reported results of operations? (FASB No. 8, paragraphs 32-34)				
22. For financial statements issued by development stage enterprises for the years beginning on or after January 1, 1976:				
a. Are financial position, changes in financial position, and results of operations presented in conformity with generally accepted accounting principles that apply to established operating enterprises? (FASB No. 7, paragraph 10)				
b. In addition to the basic financial statements does disclosure include amounts of cumulative revenue, expenses, net losses,				

## B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
changes in financial position and stockholders' equity since inception? (FASB No. 7, paragraph 11)				
c. Do the financial statements identify the enterprise as a "development stage enterprise" and include a description of the nature of its development stage activities? (FASB No. 7, paragraph 12)				
23. For an enterprise in its first fiscal year in which it is no longer considered to be in the development stage, is there disclosure that in prior years it had been in the development stage? (FASB No. 7, paragraph 13)				
24. Are appropriations of retained earnings for loss contingencies clearly identified and included within the stockholders' equity section of the balance sheet? (FASB No. 5, paragraph 15)				
25. Is interperiod tax allocation employed for oil and gas producing companies with respect to intangible drilling and development cost and other costs associated with the exploration for and development of				



B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

YES	NO	N/A	REMARKS

oil and gas revenues? (FASB No. 9, paragraphs 11-14. Note: FASB No. 9 is superseded by FASB No. 19 for fiscal years beginning after December 15, 1978.)

26. Have the requirements to disclose probable reversals of timing differences, and timing differences for which there have not been any income tax allocation been met? (FASB No. 9, paragraph 15. Note: FASB No. 9 is superseded by FASB No. 19 for fiscal years beginning after December 15, 1978.)

27. Are the financial statements adjusted for any changes in estimates resulting from subsequent events that provided additional evidence with respect to conditions that existed at the date of the balance sheet? (SAS No. 1, sections 560.03, 560.04 and 560.07)

28. Are subsequent events that provide evidence with respect to conditions that did not exist at the date of the balance sheet but arose subsequent to that date adequately disclosed to keep the financial statements from being misleading? (SAS No. 1, sections 560.05, 560.06, 560.07 and 560.09)

## B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

YES NO N/A REMARKS

29. For a marketable equity securities portfolio is the carrying amount the lower of aggregate cost or market value, and is the amount by which aggregate cost exceeds market value accounted for as a valuation allowance? (FASB No. 12, paragraph 8)				
30. For marketable equity securities, except if the equity basis is appropriate, (in statements for periods ending on or after 12/31/75) is there disclosure of the following (FASB No. 12, paragraphs 12 and 23):				
a. Aggregate cost and market value (each segregated between current and non-current classifications if applicable) as of the date of each balance sheet presented?				
b. As of the date of the latest balance sheet presented, the gross unrealized gains and gross unrealized losses (segregated between current and non-current portfolios if applicable)?				
c. For each period in which an income statement is presented:				
(1) Net realized gain or loss included in the determination of net income?				

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
(ii) Basis on which cost was determined in computing realized gain or loss (i.e., average cost or other method used)?				
(iii) Change in the valuation allowance?				
31. For marketable equity securities owned at the balance sheet date, if significant net realized and net unrealized gains and losses arose after the balance sheet date but before issuance of the financial statements, are those net realized and net unrealized gains and losses disclosed in the notes to financial statements? (FASB No. 12, paragraph 13)				
32. For enterprises in industries having specialized accounting practices with respect to marketable securities does disclosure conform with FASB No. 12, paragraphs 14-17?				
33. If a decline in market value below cost of a given marketable security is judged to be other than temporary, and changes in carrying amounts are included in stockholders' equity rather than net income, is the cost				

## B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
basis of the security written down to a new cost basis and the amount of the writedown accounted for as a realized loss? (FASB No. 12, paragraph 21)				
34. Are income tax effects for unrealized gains and losses on marketable securities accounted for according to APB No. 11? (FASB No. 12, paragraph 22)				
35. For unrealized capital losses of marketable securities are tax effects recognized only when there exists assurance beyond a reasonable doubt that the benefit will be realized by an offset of loss against capital gains? (FASB No. 12, paragraph 22)				
36. If the entity is a subchapter S corporation for federal income tax purposes, do the disclosures appear adequate?				
37. Does the statement of changes in financial position:				
a. Include a presentation for each period for which an income statement is presented? (APB No. 19, paragraph 7)				

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	REMARKS		
	YES	NO	N/A
b. Disclose all important aspects of financing and investing activities regardless of whether cash or other elements of working capital are directly affected? (APB No. 19, paragraph 8)			
c. Begin with income or loss before extraordinary items? (APB No. 19, paragraph 10)			
d. Include or be accompanied by a presentation of net changes in each element of working capital? (APB No. 19, paragraph 12)			
38. If required, do the financial statements include appropriate segment information? (FASB No. 21, paragraphs 12-16; FASB No. 14, paragraphs 9-39)			
39. Are stock subscriptions receivable appropriately identified and presented as a deduction from capital, or, if presented as an asset, stated separately, clearly labeled, and their status clearly described to distinguish them from any other type of asset?			

## B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
40. Based on the reviewer's study of the workpapers and other evidential matter, does it appear that disclosures in the financial statements are reasonably adequate? (i.e., do they comply to the third standard of reporting—SAS No. 1, section 430)				
41. Are the financial statements suitably titled? (Certain titles are generally understood to be applicable only to statements that present information in conformity with generally accepted accounting principles) (SAS No. 14, paragraph 7)				
42. Oil and gas producing companies only: For fiscal years beginning after December 15, 1978, do the financial statements reflect the accounting practices promulgated in FASB No. 19?				
43. Other remarks.				

.09

NOTE:

**PART THREE**  
**C. PERMANENT FILES**

Firm policies can vary relative to account analyses carried in the permanent file. The reviewer should be aware that some of the analyses mentioned in this section may appear in other sections of the working papers. (e.g. as carryforward analyses.)

	YES	NO	N/A	REMARKS
1. Does the permanent file contain:				
a. Copies or digest of certificate of incorporation and bylaws?				
b. Copies or excerpts from:				
i. Minutes of meetings —				
Stockholders?				
Directors?				
Executive Committee?				
ii. Important contracts and agreements (e.g. leases, loan agreements, pension plans, etc.) and accompanying abstracts that highlight items of accounting and financial reporting significance?				
c. Analyses of the client's following accounts, as appropriate through current period under review:				
i. Investments in subsidiaries?				
ii. Property, plant and equipment?				
iii. Accumulated depreciation?				

C. PERMANENT FILE (Continued)

	YES	NO	N/A	REMARKS
iv. Intangible assets and allowances?				
v. Long-term debt?				
vi. Other long term accruals and allowances?				
vii. Capital stock?				
viii. Treasury stock?				
ix. Additional paid-in capital?				
x. Retained earnings?				
xi. Other stockholder equity accounts?				
d. Company organizational chart?				
e. Detailed organizational chart of accounting department?				
f. The company's detailed chart of accounts and accounting manual currently in use or adequate equivalents?				
g. Background information such as a brief history of the company, memorandums describing plant visits, and articles or clippings that describe the company's industry?				



C. PERMANENT FILE (Continued)

	YES	NO	N/A	REMARKS
2. Was the permanent file updated during the most recent audit?				
3. Is the permanent file adequately indexed?				
4. Other remarks?				

.10

NOTE:

The second standard of field work is: "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.  
The study and evaluation often provides, as a by product, a basis for constructive suggestions to clients concerning improvements in internal control."

**D. INTERNAL CONTROL**

YES NO N/A REMARKS

1. Has an adequate understanding of the system of internal control been obtained and recorded? (SAS No. 1, sections 320.06—320.54)				
2. Was a preliminary evaluation made to identify and distinguish those controls to be relied upon in determining the extent of substantive tests? (SAS No. 1, sections 320.54 and 320.64—320.68)				
3. Were adequate compliance tests made of those internal controls to be relied upon in determining the nature, timing or extent of substantive tests? (SAS No. 1, sections 320.55—320.63)				
4. Were compliance tests of internal control confined to necessary areas? (SAS No. 1, sections 320.55 and 320.56)				
5. If the client had EDP applications, were they included in the study and evaluation of internal control? (SAS No. 3)				

D. INTERNAL CONTROL (Continued)

	YES	NO	N/A	REMARKS
6. If the client's organization included an internal audit function, was it considered in the study and evaluation of internal control? (SAS No. 9)				
7. Did the program of substantive tests reflect the conclusions reached from the study and evaluation of internal control? (SAS No. 1, sections 320.64—320.75)				
8. For periods ending on or after December 24, 1977, has the auditor communicated any material weaknesses in internal control to senior management and the Board of Directors as required by SAS No. 20?				
9. If reports on internal control were issued, were the reports in accordance with SAS No. 1, section 640 and SAS No. 20?				
10. If reports on internal control were based on criteria established by government agencies, were the reports in accordance with SAS No. 1, section 641?				
11. Other remarks?				

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E. CASH

REMARKS			
YES	NO	N/A	

1. Was a summary prepared where appropriate segregating cash (as to cash in banks, on hand, etc.) as of the balance sheet date?
2. Were cash counts made on a surprise basis when appropriate?
3. On the basis of information contained in the workingpapers, do you agree that examination of cash funds and undeposited receipts did (did not) require simultaneous physical examination of negotiable assets such as marketable securities, notes receivable and collateral held as security on loan to others?
4. Was due consideration given to cash transactions shortly before and shortly after the balance sheet date to determine that transactions were recorded in the proper period?
5. Were all bank accounts confirmed at the examination date and were all reconciling items (deposits in transit, outstanding checks, etc.) existing at the balance sheet date cleared by reference to subsequent statements obtained directly from the bank?

E. CASH (Continued)

	YES NO N/A			REMARKS
6. Where the standard bank confirmation form was used were <u>all</u> questions on the form:				
a. Answered - either positively or negatively by the respondent?				
b. Followed up - referenced to such relevant working papers as loans payable and commitments?				
7. Do the working papers (current or permanent) contain a list of officers and/or employees authorized to approve:				
a. Checks?				
b. Notes?				
8. Were cash receipts and disbursements reconciled with deposits and withdrawals - for a test period?				
9. Do the working papers indicate that the following were considered:				
a. Restrictions on cash balances?				
b. Confirmation of such bank credit arrangements as compensating balances?				

E. CASH (Continued)

	YES	NO	N/A	REMARKS
c. Review of confirmation responses for indication of related party transactions?				
d. Confirmation of liabilities and contingent liabilities to banks?				
10. Based on the evaluation of internal control, do the substantive tests of cash appear adequate?				
11. Other remarks?				

F. RECEIVABLES

12.

	YES	NO	N/A	REMARKS
1. Was a summary prepared properly classifying receivables; (i.e. notes and accounts receivable; trade; officers, directors and employees; parent and subsidiary companies; other related party transactions etc.)?				
2. Was the reasonableness of allowances for doubtful accounts covered in the workingpapers?				
3. Was collateral (if any) for receivables examined with respect to existence, ownership and value?				
4. If accounts receivable were confirmed on a test basis, does the sample appear adequate?				
5. If both positive and negative confirmation procedures were used, did there appear to be a proper distribution between positive and negative requests?				
6. Where positive confirmation procedures were used, were second requests sent, and other appropriate follow-up steps taken?				
7. Is there indication that all differences disclosed by confirmation procedures were satisfactorily cleared?				

## F. RECEIVABLES (Continued)

YES NO N/A REMARKS

8.	If a significant number and amount of accounts receivable were for some reason not circularized, is there evidence that other auditing procedures were performed?				
9.	If confirmation work was performed prior to year-end, is there evidence that an adequate review of transactions from the confirmation date to the balance sheet date was made?				
10.	Were significant notes receivable confirmed as of the audit date?				
11.	Were the results of confirmation procedures summarized in the working papers?				
12.	Do the working papers indicate that adequate evidential matter had been accumulated for confirmation of receivables? (SAS No. 1, section 33D)				
13.	Were adequate tests made of discounts and allowances?				
14.	Was receivable work correlated with the sales and inventory cut-off examination?				



F. RECEIVABLES (Continued)

	YES	NO	N/A	REMARKS
15. Is there evidence in the working papers that inquiry was made, and consideration given to whether receivables are pledged or factored?				
16. Based on the evaluation of internal control, do the substantive tests of receivables appear adequate?				
17. Do the working papers (current or permanent) contain a list of officers and/or employees authorized to approve bad debt write-offs?				
18. Are notes receivable accounted for to reasonably represent the present value of the consideration exchanged and an appropriate interest rate? (APB No. 21)				
19. Other remarks?				



G. INVENTORIES (Continued)

	YES	NO	N/A	REMARKS
d. Evidence that cut-off was adequate (at physical inventory date as well as balance sheet date) with respect to:				
i. Purchases received?				
ii. Work in process transferred?				
iii. Shipments of finished goods?				
iv. Returns?				
5. Where the physical inventory is taken at a date other than the balance sheet date (or where rotating procedures are used) do the working papers indicate that consideration was given to inventory transactions between the inventory date(s) and the balance sheet date?				
6. Based on the inventory quantity, type, location, etc., does it appear that the observation was adequate, but not excessive? (SAS No. 1, section 331)				
7. Do the working papers indicate that adequate tests were made of:				
a. The clerical accuracy of the compilation of the inventory?				

## G. INVENTORIES (Continued)

	YES NO N/A			REMARKS
	YES	NO	N/A	
b. Cost finding methods and substantiation of cost used in pricing all elements (raw materials, work in process, finished goods) of the inventory?				
8. If perpetual inventory records are maintained, do the workingpapers indicate that differences disclosed by the client's physical inventory (or cycle counts) are properly reflected in the accounts?				
9. Was an examination of purchase and sales commitments made, including consideration as to any possible adverse affects?				
10. Where applicable, were gross profit percentage tests employed to check overall valuation of inventories?				
11. Do the workingpapers indicate that obsolescence and necessity for a valuation reserve were considered?				
12. Do the workingpapers contain a write-up concerning the clients:				
a. Inventory policies?				
b. Scrap inventory?				
c. Obsolescent inventory?				
d. Write-off policies?				

G. INVENTORIES (Continued)

REMARKS

N/A

YES NO


13. Was consideration given to observing the count of inventory in the hands of others?
14. Where the physical inventory in the hands of others was not observed, were inventory confirmations received (i.e. inventory in public warehouses, on consignment, etc.)?
15. Was an inventory representation obtained from the client? (SAS No. 19)
16. Do the working papers indicate that steps were performed to determine if any inventory is pledged?
17. Based on the evaluation of internal control, do the substantive tests of inventory appear adequate?
18. Other remarks?

14	H. INVESTMENTS	REMARKS		
		YES	NO	N/A
1.	Was a summary schedule prepared (or obtained) and details examined with respect to description, purchase price and date, changes during period, income, market value, etc. of investments?			
2.	Were all securities (including stock certificates of subsidiary companies) either examined or confirmed?			
3.	Is there indication that securities were examined at the time of cash counts, where appropriate?			
4.	Was a summary schedule prepared (or obtained) with respect to the classification of investments (e.g. marketable securities, long-term investments)?			
5.	Was investigation made of carrying value and possible cost impairment of long-term investments?			
6.	Do the workingpapers indicate that consideration was given to indications that investments were pledged?			
7.	Did the working paper formats sufficiently support the reporting requirements of FASB No. 12, and APB No. 18?			

H. INVESTMENTS (Continued)

YES	NO	N/A	REMARKS

8. For investments accounted for on the equity method, were financial statements and other information reviewed to support the amounts presented?

9. Was the examination of investments correlated with related income accounts and accrued receivables?

10. Do the working papers indicate that adequate evidential matter had been accumulated for long-term investments? (SAS No. 1, section 332)

11. Other remarks?





I. PREPAID EXPENSES, INTANGIBLE ASSETS, DEFERRED CHARGES, ETC. (Continued)

	YES	NO	N/A	REMARKS
5. Were differences among amounts of insurance coverage, the insurable value (if available) and the recorded amount of insured property noted and followed-up with appropriate inquiry of the client?				
6. Were prepayments of interest and taxes related to the underlying obligations and tax bills?				
7. For capital leases, is the imputed interest amortized so as to produce a constant periodic rate of interest on the remaining balance of the obligation? (FASB No. 13, paragraph 12)				
8. Other remarks?				

J. PROPERTY, PLANT AND EQUIPMENT

YES NO N/A REMARKS


1. Was a summary schedule prepared or obtained to show beginning balances, changes during the period and ending balances for:
  - a. Property, plant and equipment?
  - b. Accumulated depreciation?
2. Do the working papers indicate that consideration was given to proper accounting treatment and that the tests appear adequate with respect to:
  - a. Additions (including facilities under construction):
    - i. Examination of physical documents?
    - ii. Physical inspection?
  - b. Retirements, etc. (including examination of miscellaneous income, scrap sales, etc.)?
  - c. The adequacy of current and accumulated provisions for depreciation and depletion?
  - d. Compliance with internal control procedures?

J. PROPERTY, PLANT AND EQUIPMENT (Continued)

YES	NO	N/A	REMARKS

e. Status of idle facilities?

3. Was an investigation made of internal control procedures with regard to properties, including the distinction between capital and expense charges?

4. Have leases been examined to determine that capital, sales, and direct financing leases have been properly accounted for? (FASB No. 13, paragraphs 6-14, 17, 18, 20-22, and 24-27; FASB No. 17, paragraph 8 if lease entered into on or after January 1, 1978)

5. Were differences between book and tax depreciation reconciled?

6. Do working papers indicate that a review was made to see that:

a. Applicable investment tax credits were taken?

b. Applicable investment credit recapture provisions were considered?

## J. PROPERTY, PLANT AND EQUIPMENT (Continued)

YES	NO	N/A	REMARKS

7. Do the working papers indicate the presence of liens on property?

8. Other remarks?

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[illegible]

K. CURRENT LIABILITIES (Continued)

	YES	NO	N/A	REMARKS
5. If payables were confirmed, do workingpapers:				
a. Indicate the basis of selection?				
b. Contain reconciliations of differences?				
6. Was an adequate test made of subsequent transactions (i.e. cash disbursements, voucher register entries, vouchers, unpaid invoices, etc.) to determine if any material unrecorded liabilities existed?				
7. Based on the evaluation of internal control, do the substantive tests of liabilities appear adequate?				
8. Was the payable work correlated with the purchase cut-off examination?				
9. Is there evidence that the examination of accrued liabilities was correlated with related expense accounts?				

K. CURRENT LIABILITIES (Continued)

	YES	NO	N/A	REMARKS
10. Do the workingpapers indicate that the following accruals are adequate in amount:				
a. Interest?				
b. Payroll (including payroll taxes)?				
c. Federal income taxes?				
d. Other taxes?				
11. Do the workingpapers indicate the latest year tax returns were examined for:				
a. Federal?				
b. State?				
c. City?				
d. Other?				

K. CURRENT LIABILITIES (Continued)

	YES NO N/A			REMARKS
12. Were revenue agents' adjustments, if any, reflected in the clients accounts for:				
a. Federal income taxes?				
b. State income and franchise taxes?				
c. City income taxes?				
d. Other?				
13. Are differences reconciled between taxable net income and book (i.e. financial statement) net income?				
14. Were the substantive tests of notes and loans payable related to applicable liabilities for accrued interest and interest expense?				
15. Are notes payable accounted for to reasonably represent the present value of the consideration exchanged and an appropriate rate of interest? (APB No. 21)				
16. Do the working papers (current or permanent) contain a list of officers and/or employees authorized to approve purchase orders?				
17. Other remarks?				



L. LONG-TERM DEBT

REMARKS

YES NO N/A


1. Was a schedule prepared or obtained summarizing long-term debt (and current portion thereof) including changes during the year?
2. Were confirmations received for significant debt obligations, together with verification of interest rates, repayment period, etc.?
3. Is there evidence that a review was made where appropriate, of agreements pertaining to outstanding long-term obligations?
4. Is there evidence that covenants to long-term debt obligations are being complied with?
5. Were unusual increases or decreases in long-term obligations traced to authorizations (e.g. stockholder or board of directors meeting minutes)?

L. LONG-TERM DEBT (Continued)

YES NO		N/A	REMARKS

6. Were substantive tests for long-term debt related to those of applicable liabilities for accrued interest and interest expense?

7. Have leases been examined to determine that capital leases have been properly accounted for? (FASB No. 13, paragraphs 6-14 and FASB No. 17, paragraph 8)

8. Other remarks?

M. DEFERRED CREDITS

.19

	YES	NO	N/A	REMARKS
1. Do the working papers indicate that:				
a. The basis of deferring income is reasonable and on a consistent basis from year to year?				
b. Deferrals have been established on a reasonable basis?				
2. Were deferred tax accrual accounts analyzed and reviewed as to adequacy?				
3. With respect to allowances established through charges to operations, has it been ascertained that subsequent charges there-against are in accordance with the intent of the account and that such subsequent charges should not have been made against operations?				
4. Have leases been examined to determine that sales and direct financing leases have been properly recorded? (FASB No. 13, paragraphs 6-9, 17 and 18)				

## M. DEFERRED CREDITS (Continued)

YES	NO	N/A	REMARKS

5. For sales and direct financing leases, is the unearned income amortized over the lease term so as to produce a constant periodic rate of return on the net investment in the lease? (FASB No. 13, paragraphs 17b and 18b) (Also see APB No. 21, paragraph 16 on recording of premium and/or discount)

6. Other remarks?

COMMITMENTS AND CONTINGENCIES

N.

REMARKS

YES NO N/A


1. Do the working papers include indication of the following:

a. Inspection of minutes of meetings of the stockholders, board of directors, and executive and other committees of the board?

b. Inspection of contracts, loan agreements, leases, and correspondence from taxing and other governmental agencies, and similar documents?

c. Accumulation and analysis of confirmation responses from banks?

d. Inspection of other documents for possible guarantees by the client?

2. Have items of financial significance found in the company's minutes, important contracts, agreements, etc., been cross-referenced to supporting analyses?

3. Is there indication that procedures were performed to uncover the need for recording or disclosure of events subsequent to the date of the financial statements? (SAS No. 1, sections 560.10, 560.11 and 560.12)

## N. COMMITMENTS AND CONTINGENCIES (Continued)

REMARKS

YES NO N/A

4. Concerning litigation, claims and assessments, do the working papers include:

- a. Descriptions and assurances that were obtained from the client's management as prescribed in SAS No. 12? (Paragraphs 5a and 5d)
- b. Indication that relevant documents including correspondence and invoices from lawyers were examined? (SAS No. 12, paragraph 5c)
- c. Reference to results of other audit procedures that might also disclose litigation, claims and assessments? (SAS No. 12, paragraph 7)
- d. Letters of audit inquiry to the client's attorneys? (SAS No. 12, paragraphs 8 and 9)
- e. Letters of response from the client's attorneys? (SAS No. 12, paragraphs 10-14)

N. COMMITMENTS AND CONTINGENCIES (Continued)

YES	NO	N/A	REMARKS

- 5. Have written representations been obtained from management as required by SAS No. 19?
- 6. Other remarks?

		CAPITAL ACCOUNTS			REMARKS
		YES	NO	N/A	
21.	0.				
1.	Have summaries and adequate analyses been made of changes in:				
	a. Capital stock?				
	b. Additional paid-in capital?				
	c. Treasury stock?				
	d. Retained earnings?				
2.	Were changes in capitalization checked to authorizations?				
3.	Was a confirmation received from the transfer agent or the registrar (or both) as to capital stock issued and outstanding?				
4.	Where no transfer agent exists, was an adequate examination of stockholders' ledger and stock certificate books made?				
5.	Were treasury stock certificates examined or confirmed?				
6.	Were treasury stock transactions checked to:				
	a. Bylaws?				
	b. State laws?				
	c. Etc.?				



O. CAPITAL ACCOUNTS (Continued)

7. Do the working papers indicate that adequate inquiries were made where appropriate, as to:	YES	NO	N/A	REMARKS
a. Stock options?				
b. Warrants?				
c. Rights?				
d. Redemptions?				
e. Conversion privileges?				
8. When appropriate, were the propriety and authorization of dividend payments verified?				
9. With respect to partnerships and individual proprietorships, do the analyses of capital and drawing accounts appear adequate?				
10. Other remarks?				

P. INCOME AND EXPENSES

REMARKS

YES NO N/A

.22

1. Do the working papers evidence:

a. That an "analytic review" of accounts not individually analyzed, was made for:

i. Balance Sheet accounts?

ii. Income Statement accounts?

b. That specific accounts analytically reviewed, were selected for tests?

c. The basis used for the selection of items tested?

2. Were gross profit ratios for the current year compared with similar statistics for prior years and were substantial variations investigated?

3. Do working papers indicate that consideration was given to sales and purchase cut-off?

4. Were adequate tests made of payrolls, including account distribution?

5. If employees are paid at the client's location, do the working papers indicate:

a. That an observation was made of a payout?

P. INCOME AND EXPENSES (Continued)

	YES	NO	N/A	REMARKS
b. That signatures of employees were requested?				
c. That signatures obtained were compared to a signatory record?				
6. With regard to pension and profit sharing plans, (including impact of ERISA) do tests made of the expense and liabilities appear adequate?				
7. Were foreign currency transactions translated into dollars in accordance with FASB No. 8? (Paragraphs 6-31; FASB No. 20, paragraphs 9-14)				
8. Have exchange gains and losses been included in the determination of net income in accordance with FASB No. 8? (Paragraphs 16, 17, and 22-28; FASB No. 20, paragraphs 9-14)				
9. Have estimated loss contingencies been accounted for in conformity with FASB No. 5? (Paragraphs 8-15)				
10. Do the working papers support the financial reporting for segments of a business enterprise for fiscal years beginning after December 15, 1976 if required; (FASB No. 21, paragraphs 12-16; FASB No. 14, paragraphs 6-8; SAS No. 21, paragraphs 1-7)				

P. INCOME AND EXPENSES (Continued)

YES NO N/A			REMARKS

11. Were revenue and expenses for the period examined compared with those of the preceding period and reviewed for reasonableness; were significant fluctuations explained?
12. Concerning earnings per share if required (see FASB No. 21), do disclosures appear adequate with regard to:

a. Capital structure (where complex securities are involved)? (APB No. 15, paragraph 19)

b. Basis upon which calculations are presented for:

1. Primary earnings per share? (APB No. 15, paragraphs 24-39)

11. Fully diluted earnings per share? (APB No. 15, paragraphs 40-42)

P. INCOME AND EXPENSES (Continued)

REMARKS			
YES	NO	N/A	

- 13. Based upon the evaluation of internal control, do the substantive tests (review, analysis, and testing) of income and expense appear adequate?
- 14. Other remarks?

WORKING PAPERS

Q.

YES	NO	N/A	REMARKS

1. Have all procedures called for in "audit programs" been signed and dated?
2. Does firm policy require that memoranda and working papers explain the basis for resolution of difficult accounting and auditing problems?
3. Do the working papers indicate that the staff are informed of new technical pronouncements, regulatory requirements and tax developments? (SAS No. 4, paragraphs 15-16)
4. Has a letter of representation been obtained from management in accordance with SAS No. 19 for:

a. Assets:

1. Inventory?

11. Other?

b. Liabilities, commitments, contingencies, and subsequent events? (SAS No. 1, section 560.12e)
- c. Identity of related parties and transactions with them? (SAS No. 6, paragraph 12b)



## Q. WORKING PAPERS (Continued)

	YES	NO	N/A	REMARKS
c. Account or subject matter examined?				
d. Date of preparation?				
e. Initials of reviewer?				
10. Are odd-sized working papers mounted on regular working papers where appropriate?				
11. Are all working papers in some logical order, indexed and cross-referenced?				
12. Are sources of information clearly documented?				
13. If statistical sampling procedures were employed, do the working papers contain:				
a. A write-up discussing the basis for the selections used?				
b. A write-up concerning the conclusion reached in applying the sample used?				



Q. WORKING PAPERS (Continued)

	YES	NO	N/A	REMARKS
14. Were procedures applied to unaudited replacement cost information in accordance with SAS No. 18?				
15. Are all symbols (tick marks) clearly explained?				
16. Do the working papers avoid unnecessary detail?				
17. Have all notes, questions or exceptions posed by staff men performing the audit, been followed up and resolved?				
18. Have notes, questions or exceptions posed by the partners or managers review been resolved?				
19. Are suggestions for changes in audit procedures for the next examination included in the working papers?				
20. Other remarks?				

R. AUDIT PLANNING, ADMINISTRATION AND REVIEW PROCEDURES

.24

YES NO N/A REMARKS

1. Did engagement planning appear to include consideration of the subjects detailed in SAS No. 22, paragraphs 3 and 7?				
2. Was a written audit program responsive to the needs of the engagement developed in light of strengths and weaknesses of internal control, and approved by the parties in charge of the engagement? (SAS No. 1, section 320, SAS No. 22, paragraph 5)				
3. Did it appear from the working papers that staff assistants were:				
a. Involved in the planning process if at the senior-supervisory level? (SAS No. 1, section 310; and SAS No. 4, paragraphs 11 and 12)				
b. Informed of their responsibilities and the objectives of the procedures that they were to perform? (SAS No. 22, paragraph 10)				
c. Subjected to appropriate review of their work performed (SAS No. 22, paragraph 11)				
d. Efficiently employed (i.e., did the senior delegate work appropriately)?				

R. AUDIT PLANNING, ADMINISTRATION AND REVIEW PROCEDURES (Continued)

	YES	NO	N/A	REMARKS
4. Were specialists such as computer audit or industry specialists utilized as needed? (SAS No. 1, section 210; SAS No. 3, paragraph 4, SAS No. 4, paragraph 7)				
5. If the firm has succeeded a predecessor auditor, was there appropriate communication with the predecessor as to the reason for the change? (SAS No. 7, paragraphs 4-7)				
6. Did the planning and execution of the engagement include consideration of the possibility of errors and irregularities such as override of control procedures? (SAS No. 16, paragraphs 6-15)				
7. Were applicable industry accounting and audit guides used for the engagement?				
8. Did it appear from the working papers that appropriate consideration was given to:				
a. Statistical sampling procedures?				
b. Effective use of client's staff to prepare analyses and schedules?				

R. AUDIT PLANNING, ADMINISTRATION AND REVIEW PROCEDURES (Continued)

	REMARKS		
	YES	NO	N/A
c. Effective allocation of work to preliminary (interim) and year end dates?			
9. Did audit planning and administration include:			
a. Development of estimates and budgets for time required by various staff classification?			
b. Recording of actual time incurred during the engagement?			
c. Appropriate use of progress reports during the engagement?			
d. Evaluation of time budgeted for the engagement and actual time incurred?			
10. If required by firm policy, was an appropriate engagement letter used?			
11. Were errors, irregularities, or illegal acts, if any, followed-up in accordance with SAS Nos. 16 and 17?			
12. If SEC reporting was required,			
a. Did the work performed and the report appear to comply with SEC			

R. AUDIT PLANNING, ADMINISTRATION AND REVIEW PROCEDURES (Continued)

YES	NO	N/A	REMARKS

requirements (especially recent releases)?

b. If required by firm policy, was an SEC checklist used?

13. Other remarks?

**PART FOUR**  
**COMMENTS FOR DISCUSSION**

.25

SECTION	COMMENTS
3. C. Permanent File Paragraph .09	
3. D. Internal Control Paragraph .10	
3. E. Cash Paragraph .11	
3. F. Receivables Paragraph .12	

COMMENTS FOR DISCUSSION (Continued)

SECTION	COMMENTS
3. G. Inventories Paragraph .13	
3. H. Investment Paragraph .14	
3. I. Prepaid Expenses Intangible Assets, Deferred Charges, etc., Paragraph .15	
3. J. Property, Plant and Equipment Paragraph .16	
3. K. Current Liabilities Paragraph .17	

(Continued)

COMMENTS FOR DISCUSSION

SECTION	COMMENTS
3. L. Long-Term Debt Paragraph .18	
3. M. Deferred Credits Paragraph .19	
3. N. Commitments and Contingencies Paragraph .20	
3. O. Capital Accounts Paragraph .21	
3. P. Income and Expenses Paragraph .22	



(Continued)

COMMENTS FOR DISCUSSION

SECTION	COMMENTS
<p>3. Q. Working Papers Paragraph .23</p>	
<p>3. R. Audit Planning, Administration and Review Procedures Paragraph .24</p>	
<p>2. A. Auditor's Report Paragraph .07</p>	
<p>2. B. Financial Statements and Footnotes Paragraph .08</p>	

➡ The next page is 31,149. ⬅



## NOTICE TO USERS

The quality control standards committee intends that this checklist be used as a tool by trained personnel in reviewing working papers and reports of unaudited statement engagements in connection with technical standards reviews provided under the AICPA voluntary quality control review program for CPA firms. Such reviews are confidential consulting reviews that result in an oral report by the reviewers. The checklist is also available, upon request, for purchase by AICPA members subject to their recognition of the following:

1. This checklist is a "tool" and in no way represents official positions or pronouncements of the AICPA.
2. It is intended as a guide rather than a fixed program, and in application it will probably require some modification depending on the size and nature of the engagements being reviewed.
3. Pronouncements issued after preparation of this checklist will also require that it be modified accordingly.
4. The checklist should be used by persons having expert knowledge of generally accepted accounting principles and auditing standards and preferably by someone who has had experience in reviewing reports and working papers. An untrained person may find the checklist confusing and reach results and conclusions that may be meaningless or perhaps misleading.
5. The checklist was developed for use in reviewing engagements of general "for-profit" companies and probably will require extensive modification if applied to engagements of "not-for-profit" organizations and companies in specialized industries.

References to AICPA and FASB publications have been updated through April 28, 1978 (through SAS No. 22 and FASB Statement No. 21).

The committee welcomes and appreciates comments and suggestions about the checklist and its use. Comments by qualified users can be of valuable assistance in updating the checklist and administering the program. Your comments and suggestions should be sent to the American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, New York 10036. Attention: quality control review division

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➡ The next page is 31,151. ←



**QCR Section 20,110**

***Technical Standards Review—  
Checklist Questionnaire for  
Unaudited Statement  
Engagements***

April 1978

**INTRODUCTION**

.01 This questionnaire is not intended to be a complete test of the sufficiency of the conduct of accounting service in connection with the preparation of unaudited financial statements. Rather, it is intended as a working tool for a qualified reviewer in applying his expertise in evaluating the methods and procedures followed by a firm of independent accountants and encouraging the firm to observe reporting practices that are generally accepted by the profession.

.02 A separate questionnaire should be used for each set of workpapers reviewed.

.03 Questions are worded so that "no" answers ordinarily indicate unsatisfactory conditions. A "no" answer should be supplemented in the Remarks section with reasons for the response.

.04 After completing the review, comments pertaining to unsatisfactory conditions and the reviewer's recommendations should be summarized in the "Comments for Discussion" section to facilitate discussion of findings and conclusions with the participant.

.05 References in the checklist for Statements on Auditing Standards are to the individual Statement Numbers 1 to 22. Statement Numbers 1 through 21 appear in the Codification of Statements on Auditing Standards Numbers 1 through 21 (January, 1978), and in Volume 1, AICPA Professional Standards, as follows:

SAS No.		Section No.
2	Reports on Audited Financial Statements	509
3	The Effects of EDP on the Auditor's Study and Evaluation of Internal Control	321

SAS No.		Section No.
4	Quality Control Considerations for a Firm of Independent Auditors	160
5	The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Princi- ples" in the Independent Auditor's Report	411
6	Related Party Transactions	335
7	Communications Between Predecessor and Successor Auditors	315
8	Other Information in Documents Containing Audited Financial Statements	550
9	The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination	322
10	Limited Review of Interim Financial Informa- tion	720
11	Using the Work of a Specialist	336
12	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments	337
13	Reports on Limited Review of Interim Finan- cial Information	519
14	Special Reports	621
15	Reports on Comparative Financial Statements	505
16	The Independent Auditor's Responsibility for the Detection of Errors or Irregularities	327
17	Illegal Acts by Clients	328
18	Unaudited Replacement Cost Information	730
19	Client Representations	333
20	Required Communication of Material Weaknesses in Internal Accounting Control	323
21	Segment Information	435
22	Planning and Supervision	311

.06

TITLE SHEET

CPA Firm Reviewed:

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Office (if more than one):

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Name of Unaudited Statement  
Engagement Reviewed:

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Date of Financial Statements:

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Date of Disclaimer of Opinion:

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Date Review Commenced:

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Review Team:

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➡ The next page is 31,155. ⬅





PART A. FORMS OF DISCLAIMER OF OPINION

.07

NOTE: SAS - Statement on Auditing Standards

	YES	NO	N/A	REMARKS
1. Does a clear disclaimer accompany or appear directly on the unaudited financial statements? (SAS No. 1, section 516.04; SAS No. 10, paragraph 20c; and SAS No. 13, paragraph 4)				
2. Is each statement page clearly and conspicuously marked as "unaudited?" (SAS No. 1, section 516.04; and SAS No. 13, paragraph 4)				
3. If the unaudited statements are for the client's internal use only, and do not include all footnotes and other disclosures that may be desirable, does the disclaimer include a clear indication that the statements are restricted to internal use by the client and therefore, do not necessarily include all disclosures that might be required for a fair presentation in conformity with generally accepted accounting principles? (SAS No. 1, section 516.05)				
4. If the circumstances indicate reservations about the unaudited statements as a fair presentation in conformity with generally accepted accounting principles and the client has not "agreed to recommend revisions," does				

A. FORMS OF DISCLAIMER OF OPINION (Continued)

	REMARKS		
	YES	NO	N/A
the disclaimer include specific reference to the nature of the CPA's reservations and effect, if known, on the statements? (SAS No. 1, sections 516.06-516.07)			
5. If the unaudited statements lack the statement of changes in financial position does the disclaimer include an indication that the statements do not conform to generally accepted accounting principles because the related statement of changes is not presented? (SAS No. 1, section 516.08)			
6. Does the disclaimer avoid mention of any auditing procedures that may have been performed (unless the engagement was in connection with either letters to underwriters or agreements between a prospective buyer and seller of a business, or a limited review as contemplated in SAS Nos. 10 and 13)? (SAS No. 1, section 516.09)			
7. If the disclaimer is in connection with either letters to underwriters or agreements between a prospective buyer and seller of a business, does the disclaimer include specification that use of the letters or reports is			

(Continued)

A. FORMS OF DISCLAIMER OF OPINION

YES NO N/A REMARKS


restricted solely to the parties involved?  
(SAS No. 1, section 516.09)

8. If the accountant is not independent does the disclaimer state specifically that he is not independent and avoid any description of the reason why he is not independent?  
(SAS No. 1, section 517.01-517.03)

9. Is the disclaimer dated?

10. Is the firm familiar with the Guide for Engagements of CPAs to Prepare Unaudited Financial Statements (prepared by the task force on unaudited financial statements, auditing standards division, AICPA 1975)?

11. If the engagement is a limited review of interim financial information (See SAS Nos. 10 and 13) does the accountant's report include a disclaimer of opinion?  
(SAS No. 10, paragraph 20c; and SAS No. 13, paragraph 4)

12. Does the accountant's report to the board of directors on a limited

## (Continued)

## A. FORMS OF DISCLAIMER OF OPINION

REMARKS

YES NO N/A

review of interim financial information include a restriction on its use and conform with criteria of SAS No. 10, paragraphs 19-23?

13. Does the accountant's report on a limited review of interim financial information presented other than in a note to audited financial statements conform with the criteria of SAS No. 13, paragraphs 3-12?

14. If unaudited financial statements are presented with audited financial statements does the report include a disclaimer of opinion and are the unaudited statements clearly marked as "unaudited?"  
(SAS No. 15, paragraphs 13-15)

15. Other remarks ?

## PART B. FINANCIAL STATEMENTS AND FOOTNOTES

## NOTE:

ARB=Accounting Research Bulletin

APB=Accounting Principles Board Opinion

FASB=Statement of the Financial Accounting Standards Board

SAS=Statement on Auditing Standards

To determine the applicability of cross-referenced pronouncements their effective dates should be considered.

YES NO N/A REMARKS

1. Are comparative financial statements presented? (ARB 43, chapter 2A)				
2. Is restricted cash appropriately segregated from other cash items and properly classified? (ARB 43, chapter 3A, paragraph 6)				
3. Are the current portions of various assets and liabilities classified as current items? (ARB 43, chapter 3A, paragraphs 4-8 and FASB No. 6, paragraph 15)				
4. Are items not expected to be realized during the current operating cycle included under non-current asset captions? (ARB 43, chapter 3A, paragraphs 5 and 6)				
5. Is there adequate disclosure of the separate classes of inventory (e.g. raw materials work in process, finished goods, etc.) if material? (ARB 43, chapter 3A, paragraphs 4 and 9, chapter 4, statement 1)				

**B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)**

	YES	NO	N/A	REMARKS
6. Are inventories stated at the lower of cost as defined, or market? (If "no" does the practice of the industry allow other methods?) (ARB 43, chapter 4, statements 3 and 7)				
7. Are short-term obligations that are both intended to be refinanced on a long-term basis, and accompanied by evidence of ability to consummate the refinancing, excluded from current liabilities and accompanied by adequate footnote disclosure? (FASB No. 6, paragraphs 10-15)				
8. Is a statement of changes in financial position presented for each period for which an income statement is presented? (APB No. 19, paragraph 7)				
9. Is a summary description of the significant accounting policies presented? (APB No. 22, paragraphs 8-15)				
10. Do all the statements presented include a general reference such as "the accompanying notes are an integral part of these financial statements," and are the notes				

**B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)**

**YES      NO      N/A      REMARKS**

<p>11. numbered and referenced from the statements or appropriately captioned? (APB Statement No. 4, chapter 2, paragraph 10)</p>			
<p>Does there appear to be adequate disclosure by footnote or otherwise with respect to:</p> <p>a. Marketable securities? (ARB 43, chapter 3A, paragraph 9 and FASB No. 12, paragraphs 12, 13, 16, 17, 19 and 20)</p>			
<p>b. Notes and accounts receivable due from officers, employees, or affiliated companies? (ARB 43, chapter 1A, paragraph 5 and SAS No. 6, paragraphs 2, 16 and 17)</p>			
<p>c. Allowance for losses on receivables? (APB No. 12, paragraph 3)</p>			
<p>d. Accrued liabilities?</p>			
<p>e. The method of determining inventory costs (FIFO, LIFO, average, etc.) and recognizing any diminished utility (cost or market, whichever is lower)? (ARB 43, chapter 4, statements 3-9 and SAS No. 1, section 430.02).</p>			

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
f. Investments? (APB No. 18, paragraph 20 and FASB No. 12, paragraphs 6 and 18)				
g. Intangible assets and their amortization? (APB No. 17, paragraphs 24-31)				
h. Principles of consolidation? (ARB 51, paragraph 5)				
i. Parents' equity in net assets and net income of unconsolidated subsidiaries and affiliates? (ARB 51, paragraph 19)				
j. Translation of foreign currency transactions and foreign currency financial statements? (ARB 43, chapter 12, paragraphs 6, 8 and 9; FASB No. 8, paragraphs 32-34)				
k. Changes in accounting principles? (SAS No. 1, sections 546.01-546.11 and 546.17; APB No. 20, paragraphs 17-30; FASB No. 3, paragraphs 9-14)				
l. Business combinations accounted for as poolings of interest? (APB No. 16, paragraphs 63-65; SAS No. 1, sections 546.12 and 546.13; SAS No. 15, paragraph 12)				



(Continued)

B. FINANCIAL STATEMENTS AND FOOTNOTES

	YES	NO	N/A	REMARKS
m. Business combinations accounted for as purchases? (APB No. 16, paragraphs 95-96)				
n. Long-term construction-type contracts? (ARB 45, paragraph 15; and APB No. 22, paragraph 13)				
o. Bond indenture and loan agreement provisions? (APB Statement No. 4, paragraph 199 R-9A; and FASB No. 6, paragraph 15)				
p. Unusual accruals and allowances? (FASB Nos. 5 and 11)				
q. Changes in capital shares and in components of stockholders' equity? (APB No. 12, paragraph 10; FASB No. 6, paragraph 15)				
r. Liquidation preference of preferred stock in the equity section of the balance sheet? (APB No. 10, paragraphs 10 and 11; APB 15, paragraph 19)				
s. Number of shares of various classes of stock authorized, issued and outstanding, and the pertinent rights and privileges of the various securities outstanding? (APB No. 10, paragraphs 10 and 11; APB No. 15, paragraph 19)				

## (Continued)

## B. FINANCIAL STATEMENTS AND FOOTNOTES

## REMARKS

YES NO N/A

- |  | YES | NO | N/A | REMARKS |
|--|-----|----|-----|---------|
| t. Option agreements? (ARB 43, chapter 13B, paragraph 15; APB No. 25, paragraph 19) Is accounting proper? (APB No. 25, paragraphs 10-18) |     |    |     |         |
| u. Restrictions on retained earnings? (APB No. 6, paragraph 13; FASB No. 5, paragraph 15)  |     |    |     |         |
| v. Dating of retained earnings after a quasi-reorganization? (ARB 43, chapter 7A, paragraph 10; ARB 46)                                  |     |    |     |         |
| w. Pension plans? (APB No. 8, paragraph 46; FASB interpretation No. 3, paragraphs 4 and 5)   |     |    |     |         |
| x. Leases (including capital, operating, sales, direct financing and leveraged leases)? (FASB No. 13, paragraphs 16, 23, 47, and 48)     |     |    |     |         |
| y. Assets pledged or assigned? (FASB No. 5, paragraphs 18 and 19; SAS No. 1, section 430.02)   |     |    |     |         |

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
z. Commitments for material amounts of new construction or equipment? (FASB No. 5, paragraphs 18 and 19 and ARB 45, paragraph 16)				
aa. Contingencies? (FASB No. 5, paragraphs 9-13)				
bb. Depreciable assets (property, plant and equipment, etc.) and depreciation:				
(1) Depreciation expense for each period? (APB No. 12, paragraph 5a)				
(1i) Balances of major classes of depreciable assets by nature of function? (APB No. 12, paragraph 5b)				
(1ii) Accumulated depreciation, either by major classes of assets or in total? (APB No. 12, paragraph 5c)				
(1v) The method or methods used in computing depreciation with respect to major classes of depreciable assets? (APB No. 12, paragraph 5d)				
(v) Investment credit, method followed and amounts involved when material? (APB No. 4)				

## (Continued)

## B. FINANCIAL STATEMENTS AND FOOTNOTES

## REMARKS

YES NO N/A

cc.	Deferred income taxes? (APB No. 11, paragraphs 57-62)				
dd.	Carry forward losses for income taxes or other credits available? (APB No. 11, paragraphs 63(a) and 63(b))				
ee.	Reasons for difference of tax expense shown from customary relationship between income before taxes and tax expense? (APB No. 11, paragraph 63(c); APB No. 23, paragraph 14)				
ff.	When renegotiation refunds under government contracts cannot be accurately estimated? (ARB 43, chapter 11B, paragraphs 4 and 5)				
gg.	Prior period adjustment? (APB No. 9, paragraph 26; APB No. 20, paragraphs 27, 28, 36 and 37; FASB No. 16, paragraphs 10-17)				
hh.	Earnings per share on the face of the income statement, accompanied by an explanatory schedule or note that includes the basis of calculations? (APB No. 15, paragraphs 12-18 and 20-23)				

(Continued)

B. FINANCIAL STATEMENTS AND FOOTNOTES

REMARKS

YES NO N/A


11. Subsequent events? (SAS No. 1, sections 560.01 to 560.12 and 561.04 to 561.09 and FASB No. 5, paragraph 11)

12. Is interest on receivables and payables (including premium and discount) presented properly? (APB No. 21, paragraph 16)

13. If there are any investments in common stock accounted for by the equity method, are the income taxes on the investor's share of the investee's earnings reflected properly? (APB No. 24, paragraphs 7-10)

14. If there are nonmonetary transactions of either a nonreciprocal or exchange nature, are they recorded in accordance with APB No. 29?

15. If there is an early extinguishment of debt, is the accounting proper and are all necessary disclosures made? (APB No. 26, paragraphs 18-21; FASB No. 4, paragraphs 8-12)

16. If a segment of the business is sold, abandoned, spun off, or otherwise disposed of (or, although still operating, is the subject of a formal plan for disposal):

## B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES NO N/A			REMARKS
a. Are discontinued operations and earnings per share correctly reflected in the income statement? (APB No. 30, paragraphs 8, 9 and 12)				
b. Are disclosures made in notes describing the identity of the segment sold, the date and manner of disposal, the assets and liabilities remaining, if any, and the income or loss from operations from measurement date to the date of the balance sheet? (APB No. 30, paragraph 18)				
17. Are extraordinary items properly disclosed and classified and did they meet the criteria for consideration as extraordinary items? (APB No. 9, paragraph 17; APB No. 30, paragraphs 10, 11, 19 through 25; FASB No. 16, paragraph 16c)				
18. Are material events or transactions that are either unusual in nature, or of infrequent occurrence but not both (and therefore not meeting both criteria for classification as an extraordinary item) reported as a separate component of income from continuing operations? (APB No. 30, paragraph 26)				

**(Continued)**

**B. FINANCIAL STATEMENTS AND FOOTNOTES**

**YES    NO    N/A    REMARKS**

19.	Are related party transactions adequately disclosed in the financial statements and accompanying notes? (SAS No. 6, paragraphs 16 and 17)				
20.	Are research and development costs charged to expense when incurred, and appropriately disclosed? (FASB No. 2, paragraphs 12-16)				
21.	Are required disclosures made of aggregate exchange gains or losses and effects of rate changes on reported results of operations? (FASB No. 8, paragraphs 32-34)				
22.	For financial statements issued by development stage enterprises for the years beginning on or after January 1, 1976:  a. Are financial position, changes in financial position, and results of operations presented in conformity with generally accepted accounting principles that apply to established operating enterprises? (FASB No. 7, paragraph 10)  b. In addition to the basic financial statements does disclosure include amounts of cumulative revenue, expenses, net losses,				

## (Continued)

## B. FINANCIAL STATEMENTS AND FOOTNOTES

	YES	NO	N/A	REMARKS
changes in financial position and stockholders' equity since inception? (FASB No. 7, paragraph 11)				
c. Do the financial statements identify the enterprise as a "development stage enterprise" and include a description of the nature of its development stage activities? (FASB No. 7, paragraph 12)				
23. For an enterprise in its first fiscal year in which it is no longer considered to be in the development stage, is there disclosure that in prior years it had been in the development stage? (FASB No. 7, paragraph 13)				
24. Are appropriations of retained earnings for loss contingencies clearly identified and included within the stockholders' equity section of the balance sheet? (FASB No. 5, paragraph 15)				
25. Is interperiod tax allocation employed for oil and gas producing companies with respect to intangible drilling and development cost and other costs associated with the exploration for and development of				



B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

YES NO N/A REMARKS


oil and gas revenues? (FASB No. 9, paragraphs 11-14. Note: FASB No. 9 is superseded by FASB No. 19 for fiscal years beginning after December 15, 1978.)

26. Have the requirements to disclose probable reversals of timing differences, and timing differences for which there have not been any income tax allocation been met? (FASB No. 9, paragraph 15. Note: FASB No. 9 is superseded by FASB No. 19 for fiscal years beginning after December 15, 1978.)

27. Are the financial statements adjusted for any changes in estimates resulting from subsequent events that provided additional evidence with respect to conditions that existed at the date of the balance sheet? (SAS No. 1, sections 560.03, 560.04 and 560.07)

28. Are subsequent events that provide evidence with respect to conditions that did not exist at the date of the balance sheet but arose subsequent to that date adequately disclosed to keep the financial statements from being misleading? (SAS No. 1, sections 560.05, 560.06, 560.07 and 560.09)

## (Continued)

## B. FINANCIAL STATEMENTS AND FOOTNOTES

YES		NO		N/A	REMARKS

29. For a marketable equity securities portfolio is the carrying amount the lower of aggregate cost or market value, and is the amount by which aggregate cost exceeds market value accounted for as a valuation allowance? (FASB No. 12, paragraph 8)

30. For marketable equity securities, except if the equity basis is appropriate, (in statements for periods ending on or after 12/31/75) is there disclosure of the following (FASB No. 12, paragraphs 12 and 23):

a. Aggregate cost and market value (each segregated between current and non-current classifications if applicable) as of the date of each balance sheet presented?

b. As of the date of the latest balance sheet presented, the gross unrealized gains and gross unrealized losses (segregated between current and non-current portfolios if applicable)?

c. For each period in which an income statement is presented:

(1) Net realized gain or loss included in the determination of net income?

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
(ii) Basis on which cost was determined in computing realized gain or loss (i.e., average cost or other method used)?				
(iii) Change in the valuation allowance?				
31. For marketable equity securities owned at the balance sheet date, if significant net realized and net unrealized gains and losses arose after the balance sheet date but before issuance of the financial statements, are those net realized and net unrealized gains and losses disclosed in the notes to financial statements? (FASB No. 12, paragraph 13)				
32. For enterprises in industries having specialized accounting practices with respect to marketable securities does disclosure conform with FASB No. 12, paragraphs 14-17?				
33. If a decline in market value below cost of a given marketable security is judged to be other than temporary, and changes in carrying amounts are included in stockholders' equity rather than net income, is the cost				

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
basis of the security written down to a new cost basis and the amount of the writedown accounted for as a realized loss? (FASB No. 12, paragraph 21)				
34. Are income tax effects for unrealized gains and losses on marketable securities accounted for according to APB No. 11? (FASB No. 12, paragraph 22)				
35. For unrealized capital losses of marketable securities are tax effects recognized only when there exists assurance beyond a reasonable doubt that the benefit will be realized by an offset of loss against capital gains? (FASB No. 12, paragraph 22)				
36. If the entity is a subchapter S corporation for federal income tax purposes, do the disclosures appear adequate?				
37. Does the statement of changes in financial position:  a. Include a presentation for each period for which an income statement is presented? (APB No. 19, paragraph 7)				

(Continued)

B. FINANCIAL STATEMENTS AND FOOTNOTES

	YES	NO	N/A	REMARKS
b. Disclose all important aspects of financing and investing activities regardless of whether cash or other elements of working capital are directly affected? (APB No. 19, paragraph 8)				
c. Begin with income or loss before extraordinary items? (APB No. 19, paragraph 10)				
d. Include or be accompanied by a presentation of net changes in each element of working capital? (APB No. 19, paragraph 12)				
38. If required, do the financial statements include appropriate segment information? (FASB No. 21, paragraphs 12-16; FASB No. 14, paragraphs 9-39)				
39. Are stock subscriptions receivable appropriately identified and presented as a deduction from capital, or, if presented as an asset, stated separately, clearly labeled, and their status clearly described to distinguish them from any other type of asset?				

B. FINANCIAL STATEMENTS AND FOOTNOTES (Continued)

	YES	NO	N/A	REMARKS
40. Based on the reviewer's study of the workpapers and other evidential matter, does it appear that disclosures in the financial statements are reasonably adequate? (i.e., do they comply to the third standard of reporting—SAS No. 1, section 430)				
41. Are the financial statements suitably titled? (Certain titles are generally understood to be applicable only to statements that present information in conformity with generally accepted accounting principles) (SAS No. 14, paragraph 7)				
42. Oil and gas producing companies only: For fiscal years beginning after December 15, 1978, do the financial statements reflect the accounting practices promulgated in FASB No. 19?				
43. Other remarks.				

**PART C. ENGAGEMENT ADMINISTRATION**

**.09**

**NOTE:** GUIDE = Guide for Engagements of CPAs to Prepare Unaudited Financial Statements, prepared by the Task Force on unaudited financial statements, Auditing Standards Division, (AICPA, 1975).

	YES	NO	W/A	REMARKS
1. Was an engagement letter issued to provide a written record of the agreement with the client as to the services to be provided? (GUIDE, chapter 2)				
2. Do planning and administrative tools such as checklists, correspondence and written instructions avoid such terms as "audit" and "audit program"? (GUIDE, chapter 3)				
3. Do the working papers avoid terminology that might imply an audit was performed? (GUIDE, chapter 5)				
4. Do the working papers (including checklists and instructions) appear reasonable in relation to the following (GUIDE, chapter 5):				
a. Agreed upon scope of the engagement?				
b. Purpose and contemplated use of the unaudited statements?				
5. Do the working papers avoid unnecessary detail?				

## C. ENGAGEMENT ADMINISTRATION (Continued)

REMARKS

YES NO N/A

6. Are all working papers in a logical order, indexed and cross-referenced?				
7. Do individual working papers contain:				
a. Name of client?				
b. Initials of preparer?				
c. Account or subject matter considered?				
d. Date of preparation?				
e. Initials of reviewer?				
8. Are all tick marks and other symbols clearly explained?				
9. Have notes, questions or exceptions posed by the partners' or managers' review been cleared or resolved?				
10. Was an evaluation made of the time budgeted for the engagement and the actual time recorded?				
11. Does it appear from the working-papers that staff assistants were:				



**C. ENGAGEMENT ADMINISTRATION (Continued)**

	YES	NO	N/A	REMARKS
a. Efficiently used (i.e. did the senior delegate less important work)?				
b. Briefed about the end result of their work?				
12. Does it appear that client's staff was effectively used to prepare any required analyses and schedules?				
13. Does it appear that the inquiries and other procedures performed are adequate for the circumstances of the engagement? (GUIDE, chapter 3)				
14. Are suggestions for changes in procedures for the next engagement included in the working papers?				
15. Is the firm aware of the exposure draft by the AICPA accounting and review services committee regarding compilation and review of financial statements?				
16. Other remarks?				

PART D. COMMENTS FOR DISCUSSION

.10

PART	COMMENTS
<b>C.</b> <b>Engagement Administration</b> <b>Paragraph .09</b>	
<b>A.</b> <b>Forms of Disclaimer</b> <b>of Opinion</b> <b>Paragraph .07</b>	
<b>B.</b> <b>Financial Statements</b> <b>and Footnotes</b> <b>Paragraph .08</b>	

➡ The next page is 31,811. ⬅

## Preface

The following section has been prepared by the staff to provide guidance to firms intending to participate in the AICPA Voluntary Quality Control Review Program for CPA Firms. It has not been acted on by any senior committee, the membership, or the governing body of the American Institute of Certified Public Accountants. Therefore, the contents of this section are not official pronouncements of the AICPA.

We wish to acknowledge with appreciation the substantial help received from the quality control document task force which offered constructive criticism at various draft stages. The members of the task force are Norman S. Rachlin, chairman, Dennis R. Carson, James T. Martin, and Joseph A. Puglisi.

William C. Bruschi  
Ted M. Felix  
John F. Cullen

November 1977

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**QCR Section 20,500****Sample Quality Control Documents  
for Local CPA Firms****November 1977****Introduction**

**.01** Under the AICPA Voluntary Quality Control Review Program for CPA Firms (the “program”) a participating firm is required to document its quality control policies and procedures.<sup>1</sup> In undertaking this project of guidance for local practitioners to assist them in the development of their quality control documents, many alternatives had to be considered in determining the objectives and in implementing them. For example, while it would undoubtedly be useful to firms to be able to refer to an encyclopedia of quality control documents where one could find samples suitable to each practice size, the magnitude of such a project would be unreasonable and would undermine the fundamental concept that each firm’s quality control system is distinctive to that firm’s unique practice.

**.02** Three considerations were influential in this project. The first two were timing and appropriateness. To help make the quality control review program effective for 1978, the material should be made available to local practitioners before the end of 1977. Secondly, the sample documents should be designed to provide sufficient guidance to help the practitioners make the transition between the theoretical concepts of standards for quality control reviews and the “real world” of developing and using a quality control document in their own firms.

**.03** The third consideration was that a quality control document cannot be created in a vacuum. A quality control document must be designed to fulfill the requirements of a particular practice, for, as stated in the *Guide to Implement the Voluntary Quality Control Review Program for CPA Firms—Quality Control Policies and Procedures for Participating CPA Firms* (the “guide”) [QC section 200.04],

The underlying philosophy and organizational structure of a participating firm provide the framework for its quality control policies and procedures. The extent to which a participating firm should adopt these policies and procedures, and those which are appropriate for a particular firm, depend on a number of factors, such as its size, the degree of operating autonomy appropriately allowed to its people and its

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<sup>1</sup> *Voluntary Quality Control Review Program for CPA Firms* (New York: AICPA, 1976). Also printed in *AICPA Professional Standards*, Volume 2, QC section 100.

practice offices, the nature of its practice, and its administrative controls. Accordingly, it is expected that policies and procedures adopted, and documentation thereof, would normally be more extensive for a larger or multi-office firm than for a smaller or single-office firm.

**.04** Therefore, the drafting of sample documents first requires the availability of model practices. Such models have been identified in the *Management of an Accounting Practice Handbook* (the *MAP Handbook*) as "Profile Firms," and the smallest two of the three firms described have been used.<sup>2</sup>

**.05** As other firm models evolve and as the quality control review program develops through experience, there will be the availability of material for sample documents for other specific types of practices, such as a sole practitioner or a local firm with more than one office.

**.06** The policies and procedures discussed herein follow the format of those enumerated in the guide. During the preparation of these sample quality control documents consideration was given, in accordance with the guide, to the policies and procedures which could be applicable for a specific firm to provide itself with reasonable assurance of conformity with professional standards. The concept of reasonable assurance recognizes that economic considerations affect the conduct of a firm's practice. Therefore, the extent to which quality control policies and procedures are adopted and placed in effect may be influenced by appropriate cost/benefit considerations.

**.07** In this document, *policies* (which are numbered and in bold type) refer to the firm's objectives and goals for placing in effect the elements of quality control. *Procedures* (which are lettered) refer to the steps taken to accomplish the policies adopted. Unless otherwise stated, *personnel* encompasses all the professionals associated with the participating firm's accounting and auditing practice and includes partners, principals, and stockholders or officers of professional corporations.

**.08** The following sample quality control documents have been prepared to provide guidance to individuals in developing quality control documents for local CPA firms.<sup>3</sup> These sample documents were

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<sup>2</sup> *Management of an Accounting Practice Handbook* (New York: AICPA, 1977).

<sup>3</sup> A firm's quality control policies and procedures need not be contained in a single quality control document. A firm may meet the requirement of the program for documented quality control policies and procedures by preparing either a quality control document that provides a detailed description of its quality control policies and procedures or a summary statement of its quality control policies and procedures with references to supporting information contained in manuals, memorandums, or other technical literature of the firm.

prepared for two hypothetical firms based on two of the profile firms (A and B) described in the *MAP Handbook*. Although the sample quality control documents are directed toward firms of specific sizes, appropriately modified, they may have applicability to firms of various sizes. However, since no two firms of a similar size could be expected to be totally alike in other respects, no two quality control documents would be totally alike.

.09 Policies and procedures for firm A may be adaptable to a sole practitioner who might similarly employ several professional staff members. Assuming the sole practitioner serves in the role of the executive partner in the example, the responsibilities assigned therein to the administrative partner may be assumed in part by him and in part by one or more experienced staff members. In particularly sensitive or private areas, he may want to exchange certain responsibilities with another sole practitioner or other CPA in his community. He might find an arrangement with another CPA firm to be extremely helpful in some of the elements, such as consultation, professional development, and inspection.

.10 The background information provided for the two firms is based upon data contained in the *MAP Handbook* expanded to provide illustration. Firms undergoing compliance reviews under the program may be required to furnish background information, in addition to that which is presented with the sample documents, prior to the review.

.11 In these two sample documents consideration has been given to all of the policies enumerated in the guide. The method of adoption of each policy is in accordance with each firm's unique qualities. Similarly, procedures that implement the policies follow the format of material contained in the guide and are based upon the size, structure, and practice of each firm. The document for firm B is more extensive than the document for firm A since the structure of firm B is more complex. Also, firm B's document refers to two practice manuals used to implement its quality control system.

.12 It should be noted that firms A and B both have policies dealing with independence. While two policies are identical, firm A's policies do not mention the SEC and other regulatory agencies since its clients are not subject to such regulations. Similarly, firm A does not have a policy relating to confirming the independence of another firm engaged to perform segments of an engagement because, at present, firm A is the sole auditor of all its audit clients. Changes in firm A's practice may necessitate provision for these items at some future time.

.13 Although policy 2 for independence is identical for both firms, the procedures differ in accordance with the firms' respective prac-

tices. Firm B uses a personnel manual (procedure a) to inform personnel as to independence requirements, while firm A uses internal memorandums. Firm B regularly distributes a client listing (procedure c), while firm A informs its staff of client changes at staff meetings.

.14 The element of independence has been used to illustrate how quality control objectives have been accomplished with procedures that differ to accommodate the specific needs of each practice, similar examples are to be found in the other elements. The need for procedures that are responsive to each firm's practice should be kept in mind in the drafting of a quality control document.

.15 In preparing a quality control document for a local CPA firm that desires to participate in the program, the following steps may prove helpful:

1. Become familiar with the program and the contents of the guide.
2. Establish a schedule to accomplish various steps.
3. Gather together all current firm materials related to the elements of quality control and, if possible, obtain other firms' quality control documents; for example, forms, checklists, memorandums, and manuals presently in use.<sup>4</sup>
4. Evaluate the applicability of existing policies and procedures.
5. Adopt or revise policies and procedures as applicable.
6. Prepare the firm's background information that will explain the objectives of your firm, a brief history, and some details about type of practice.
7. Draft the quality control document element by element. As each element is written, it may be helpful to refer simultaneously to the section in the guide for the particular element and to the two sample documents contained herein.
8. Submit the draft document for review to the partners and other appropriate accounting and auditing personnel of the firm.
9. Submit, if desired, the final draft to the American Institute of Certified Public Accountants for a confidential review and written comments. (Contact the AICPA for further information.)

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<sup>4</sup> Appendix A contains sample staff-level guidelines and timetables that relate to the element of *advancement*. Appendix C contains a list of forms in the *MAP Handbook* that relate to quality control and may be adaptable to your firm.



16 The preparation of a quality control document is only the first step in becoming a participating firm. The quality control document is not a static treatise. Its contents must be communicated to all personnel, and the firm must follow its policies and procedures in the daily conduct of its practice. Revisions of the document should be made when appropriate in the light of changing conditions in the firm and to recognize evolving standards of the profession.

## Sample Quality Control Document for a Two-Partner Local CPA Firm (Profile Firm A)

### .17 Firm Background Information

Our firm was founded in 1962 by our executive partner after he had gained several years experience with a large regional CPA firm. The administrative partner joined the firm as a staff assistant upon his college graduation. Presently we employ three professional staff members and two clerical staff personnel giving our firm a total of seven people. (Our organization chart is on the next page.)

Our objectives of providing quality service to clients and our concern for the general public interest have established our reputation in our community and have enabled us to grow through internal expansion.<sup>1</sup> We do not have, nor do we anticipate accepting, publicly held corporations as clients. It is anticipated that much of our future growth will be through expanded service to present clients and the addition of new clients on a regular basis. We intend to hire and train personnel who will be able to grow professionally with us, as needed.

There were approximately 9,250 hours billed during the year ended December 31, 1977, as follows:

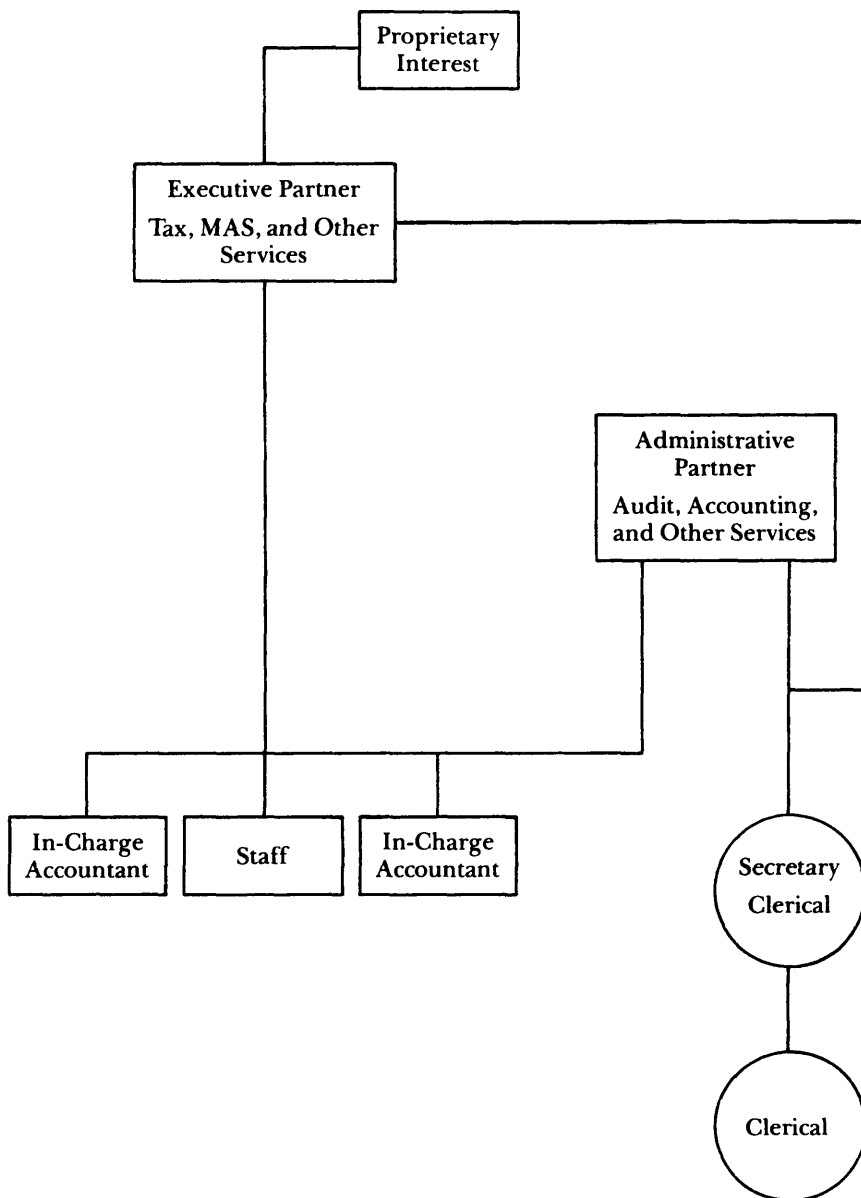
Auditing	20%
Unaudited financial statements	32
Taxes	33
Management advisory services	3
Other accounting services	12
	<u>100%</u>

Our practice is conducted from one office, and our audit clientele consists of 14 manufacturing companies, 5 retail establishments, and 2 wholesale distributors. In addition, we have 26 unaudited statements clients and 13 clients for whom we provide other accounting services.

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<sup>1</sup> The objectives stated herein are adapted from the *MAP Handbook*. Additional considerations for establishing a firm's stated objectives are discussed in Appendix B.

### Organization Chart Firm A



Reprinted from *Management of an Accounting Practice Handbook* (New York: AICPA, 1977),  
Section 502.05

One of our in-charge accountants has 5 years experience and is a CPA, the other has 3 years experience and has passed three parts of the CPA examination. The staff assistant has 1 year experience and has passed two parts of the CPA examination.

February 10, 1978

## **.18 Independence**

1. All personnel are required to adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, (state) CPA Society, (state) Board of Accountancy, and state statute.
  - a. The executive partner is responsible for resolving questions relating to independence matters and is available to provide guidance when required.
  - b. The executive partner communicates with the AICPA and/or the (state) CPA Society for assistance in resolving independence questions that are not satisfactorily resolved within the firm.
  - c. A memorandum documenting the resolution of independence questions is prepared and retained by the executive partner; the other firm personnel involved in the matter review and initial the memorandum.
2. Policies and procedures relating to independence are communicated to all personnel.
  - a. Memorandums are used to inform personnel of the firm's independence policies and procedures and advise them that they are expected to be familiar with those policies and procedures. Rulings and interpretations of the AICPA, (state) CPA Society, (state) Board of Accountancy, and state statute are also made available to personnel.
  - b. Independence of mental attitude is emphasized during the conduct of engagements.
  - c. A current client listing is reviewed with each new employee to ensure that the employee is aware of those entities to which

independence policies apply. During the monthly staff meeting, the staff is informed of any changes in the listing.

- d. Our library contains professional, regulatory, and firm literature relating to independence matters.<sup>2</sup>
- 3. Compliance with policies and procedures relating to independence is monitored.
  - a. Semiannually, at the June and December monthly staff meetings, provision is made on the agenda for all personnel to indicate that—
    - (i) They are familiar with the firm's independence policies and procedures.
    - (ii) They are not now nor have been holding prohibited investments.
    - (iii) They are not now nor have been involved in relationships or transactions that are prohibited.
  - b. The executive partner is responsible for the resolution of exceptions to the firm's policies and procedures relating to independence.
  - c. Accounts receivable that are past due are reviewed monthly by the executive partner to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

## **.19 Assigning Personnel to Engagements**

- 1. Our firm's approach to assigning personnel includes the planning of overall firm needs and the measures employed to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.
  - a. On an annual basis, normally in May of each year, the partners jointly develop a projection containing anticipated manpower requirements for the coming year.
  - b. In scheduling assignments the engagement partner strives to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.

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<sup>2</sup> The appropriate information may be found in *AICPA Professional Standards*, Vol. 2 (New York: AICPA, 1977), and in rulings and interpretations of the state CPA societies, the state boards of accountancy, and state statutes.

2. The administrative partner is responsible for assigning personnel to engagements.
  - a. Before making assignments to engagements, the engagement partner considers the nature of the engagement and personnel availability.
  - b. The partners attempt to achieve a balance between the need for continuity and for periodic rotation of personnel to the extent practicable.

## **.20 Consultation**

1. Areas and specialized situations where consultation is required are identified, and personnel are encouraged to consult with or use authoritative sources on complex or unusual matters.
  - a. All personnel are advised of our firm's consultation policies and procedures. These policies and procedures are set forth in a memorandum.
  - b. A listing of certain areas or specialized situations, which because of the nature or complexity of the subject have been identified as requiring consultation, is updated semiannually by the administrative partner and distributed to all personnel.
  - c. A technical reference library is maintained to assist personnel in resolving practice problems. The administrative partner is charged with the responsibility of periodically reviewing the library contents and making necessary additions.
  - d. Personnel are encouraged to seek advice from a partner or other staff member when confronted with an unusual or complex situation related to that person's particular expertise.
  - e. When expertise is not available within the firm, practice questions and problems are referred by the engagement partner to a division or group in the AICPA or the (state) CPA Society established to handle technical inquiries.
  - f. We maintain a consultation agreement with the local office of (firm name) CPAs to provide us with additional expertise. Inquiries to that firm are channeled through the administrative partner.
  - g. The results of outside consultation are reviewed by the partners before a decision is reached.
2. Specific individuals have been designated as having specialized experience and expertise in certain technical areas. These individuals are available for consultation to all personnel.

- a. A listing of our designated technical specialists has been prepared and circulated. The list is updated and recirculated as necessary.
  - b. The executive partner resolves differences of opinion on practice problems. Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.
3. In those areas and specialized situations where firm policy requires consultation with specialists, a summary of the consultation conclusions and the reasons for the conclusions is required.
- a. The memorandum (see item 1 (a) above) is used to inform personnel of the consultation procedures, the extent of documentation required, and the responsibility for its preparation.
  - b. Consultation summaries are filed with the engagement working papers.

## **.21 Supervision**

1. All engagements are adequately planned by persons knowledgeable about the client and/or the type of engagement.
- a. On all annual recurring engagements where the anticipated manpower requirement is in excess of ten man-days, the in-charge accountant reviews with the engagement partner the following documents from the prior year's files, as applicable, to determine if modifications are appropriate:
    - (i) Engagement letter
    - (ii) Time budget compared with actual time expended
    - (iii) Evaluation of the system of internal control
    - (iv) Audit or work program
    - (v) Engagement notes and memorandums
    - (vi) Financial statements and accountant's report
    - (vii) Management letters
  - b. On all engagements in excess of ten man-days, including annual recurring engagements, new engagements, and special engagements, the in-charge accountant submits to the engagement partner the following, where applicable, for his written approval:
    - (i) Engagement letter
    - (ii) Time budget
    - (iii) Preliminary evaluation of the system of internal control

- (iv) Audit or work program
- (v) A memorandum stating any special problems that may have an impact on the conduct of the engagement

**2. Procedures are provided for maintaining the firm's standards of quality for the work performed.**

- a. Depending upon each individual's background in relation to his assignment, varying degrees of supervision are provided.
- b. Copies of forms, checklists, and questionnaires are available for use on engagements.
- c. Differences of opinion among staff members working on an engagement are brought to the attention of the engagement partner. If the partner agrees with the senior party to the dispute, the matter is considered resolved. If no resolution is made at this time, the partners jointly discuss the matter. Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.

**3. All engagement working papers and reports are reviewed by appropriate supervisory personnel prior to issuance of the report.**

- a. The in-charge accountant reviews and initials all working papers he did not prepare (including those prepared by a partner). The engagement partner reviews the overall engagement (initialing all working papers not reviewed by an in-charge accountant), including financial statements and accountant's report, and discusses with the in-charge accountant any critical audit areas and unusual accounting matters encountered during the course of the engagement. This discussion is documented by a memorandum where appropriate.
- b. In certain circumstances (as outlined in item 1(d) at paragraph .25) prior to the issuance of the financial statements and the auditor's report on them, another partner or an experienced staff member not otherwise associated with the engagement evaluates the appropriateness of financial statement disclosures and the auditor's report in relation to the material discussed in the engagement partner's memorandum.

## **.22 Hiring**

- 1. The firm endeavors to obtain qualified personnel by planning for personnel needs and establishing hiring objectives.



- a. The partners annually plan the firm's long-range personnel objectives. Current clientele, anticipated growth, personnel turnover, individual advancement, and retirement are among the criteria considered.
  - b. The partners make the employment decisions.
- 2. Our firm has established qualifications and guidelines for evaluating potential hires.**
- a. Our firm seeks to employ individuals with high levels of intelligence, integrity, honesty, motivation, and aptitude for the profession.
  - b. Our firm normally employs college graduates with a concentration in accounting as full-time permanent members of its professional staff.
  - c. Newly employed staff members are from the top half of their college class, unless other factors such as personal achievements, work experience, and personal interests indicate the likelihood of adequate professional development.
  - d. Our firm normally expects that an applicant's academic preparation will enable him to take the CPA examination as administered by the (state) Board of Accountancy.
  - e. The backgrounds of new employees are appropriately investigated to reasonably assure hiring of persons with acceptable qualifications by obtaining completed application forms, college transcripts, and personal references.
- 3. Applicants and new personnel are informed of the firm's policies and procedures relevant to them.**
- a. The firm's personnel policies and procedures relevant to applicants are communicated to them before offers of employment are extended.
  - b. The administrative partner maintains and distributes to all personnel memorandums describing the firm's personnel policies and procedures.
  - c. The administrative partner discusses the firm's personnel policies and procedures with any new employee.

## **.23 Professional Development**

- 1. Guidelines and requirements have been established for the firm's professional development program and are communicated to all personnel.**

- a. The administrative partner is responsible for the formulation and implementation of guidelines and requirements for professional development.
  - b. As part of their orientation, new employees are informed of professional responsibilities and opportunities by the administrative partner.
  - c. Normally, a newly employed person with limited experience is sent to introductory-level training sessions of the AICPA or the (state) CPA Society during the first year of employment with our firm.
  - d. Each partner and professional employee is required to complete a minimum of 40 hours of formal continuing professional education each year. Personnel complete the record of professional development form and forward it to the administrative partner. The administrative partner is responsible for having the personnel files of each partner and professional employee updated to include a current record of hours of professional development completed. The types of programs qualifying for the fulfillment of the 40-hour requirement include—
    - (i) Continuing professional education programs of the AICPA and the (state) CPA Society. This includes sessions attended and, with written evidence of completion, cassette/workbook or workbook programs.
    - (ii) College courses related to the profession.
  - e. The executive partner annually reviews the firm's professional development program (including personnel participation records) to determine whether it is adequately meeting the firm's needs, providing for the professional growth of individuals, and meeting mandatory continuing education requirements.
2. Information about current developments in professional technical standards and materials containing the firm's technical policies and procedures are made available to personnel. Personnel are encouraged to engage in self-development activities.
- a. It is the responsibility of the administrative partner to distribute statements relating to current developments in accounting and auditing to all personnel not receiving them directly. This includes statements and interpretations issued by the Financial Accounting Standards Board and by the AICPA

Auditing Standards Executive Committee, and so forth.

- b. Pronouncements relating to areas of specific interest are distributed by the appropriate specialist to persons who have need for such information.
  - c. The firm does not, at present, conduct formal in-house training programs. However, from time to time personnel participate in the training programs of (firm name) CPAs.
  - d. A library of staff training cassette/workbook programs published by the AICPA and the (state) Society of CPAs is maintained by the administrative partner for self-study and reference purposes.
3. The firm recognizes that on-the-job training accounts for a significant part of professional development.
- a. Personnel with in-charge responsibility on engagements—
    - (i) Discuss with assistants the relationship of the work they are performing to the engagement as a whole.
    - (ii) Permit assistants, when practicable, to become involved in areas of the engagement other than those previously assigned.
    - (iii) Explain to assistants the reasons for any additional work requirements discovered through the review process.
  - b. Personnel are evaluated in part on their effectiveness in properly training and developing subordinates.

## **.24 Advancement**

- 1. Our firm has established qualifications deemed necessary for the various levels of responsibility within the firm.
  - a. Our firm has designated the staff classifications of in-charge accountant and staff assistant. Levels of responsibility inherent in the staff classifications are clearly defined.<sup>3</sup>
  - b. The criteria that are considered in evaluating individual performance and expected proficiency are enumerated in our staff classification guidelines.
- 2. The performance of our personnel is continuously evaluated, and personnel are periodically advised of their progress. Per-

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<sup>3</sup> The description of the firm's professional levels, with the responsibilities for each level and the general length of time required for advancement to the next position, is attached as Appendix A.

sonnel files are maintained containing documentation of the evaluation process.

- a. All professional employees receive an evaluation of their performance at least semiannually. Such counseling interviews are conducted by the partners. These evaluations summarize performance on engagements during the year. The individual's progress, strengths, weaknesses, future objectives, and the firm's future objectives are among the items discussed.
  - b. Results of evaluations are documented in the individual's personnel file.
3. The partners make advancement and termination decisions and document the results.

## **.25 Acceptance and Continuance of Clients**

1. Our firm has established procedures for evaluation of prospective clients and for their acceptance as clients.
  - a. Available financial information regarding the prospective client (such as annual reports, interim financial statements, and income tax returns) is obtained and reviewed.
  - b. Inquiries about potential clients are made to bankers, attorneys, credit services, and others having business relationships with the company.
  - c. Predecessor auditors, where applicable, are contacted and inquiries are made in accordance with generally accepted auditing standards.
  - d. Consideration is given to circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks. These circumstances include the following:
    - (i) Audits where the annual fee is expected to exceed \$5,000 or where the expected man-hour requirement exceeds 150 hours.
    - (ii) Audits of firms operating in high risk industries such as those industries where it is difficult to establish adequate systems of internal control or those industries whose operations are especially sensitive to general economic conditions.
    - (iii) Audits of firms in the development stage.
    - (iv) Audits of firms in serious financial difficulty.
    - (v) Any of the conditions enumerated in 2(a)(iii).

- e. The firm's independence and ability to adequately serve a potential client are evaluated prior to acceptance. In evaluating the firm's ability, consideration is given to the requirements for technical skills, knowledge of the industry, and personnel.
  - f. A review is made to ensure that acceptance of the client would not violate applicable regulatory agency requirements and the codes of professional ethics of the AICPA and/or the (state) CPA Society.
  - g. Procedures for acceptance of a new engagement are as follows:
    - (i) The engagement partner assembles the information and evaluates all matters in the previous paragraphs.
    - (ii) All engagements are approved in writing by the partners.
2. Clients are evaluated at the end of specific periods or upon the occurrence of certain events to determine whether the relationship should be continued.
- a. Reevaluations of existing clients are made—
    - (i) Annually, if any of the conditions mentioned in 1(d) exist.
    - (ii) Every three years if none of the conditions mentioned in 1(d) exist.
    - (iii) If there is a significant change in one or more of the following:
      - Management or ownership
      - Legal counsel
      - Financial condition
      - Litigation status
      - Nature of client's business
      - Scope of work
    - (iv) Upon the emergence of conditions that would have caused the firm to reject a client had such conditions existed at the time of the initial acceptance.
  - b. Based on the information obtained, both partners make the continuance decision.

## **.26 Inspection**

- 1. The firm conducts an inspection program regarding its quality control policies and procedures.

- a. Each year the partners evaluate the firm's quality control policies and procedures for compliance with professional standards. This procedure includes a review of administrative and personnel files sufficient to obtain reasonable assurance that quality control policies and procedures are being complied with.
  - b. A sample of engagements is selected annually from each partner's client listing and is given an in-depth review by the other partner or by a staff member not otherwise associated with the engagement. The working papers and reports are reviewed for compliance with professional standards, including generally accepted auditing standards, generally accepted accounting principles, and with the firm's quality control policies and procedures.
  - c. Annually, the executive partner selects a representative report to be submitted for review to the practice review committee of the (state) Society or the AICPA.
  - d. Every third year the firm undergoes an AICPA quality control compliance review.
2. Provision is made for reporting inspection findings and for monitoring actions taken or planned.
- a. The results of engagement reviews are discussed with the personnel responsible for the engagement.
  - b. Inspection findings and recommendations together with corrective actions taken or planned are discussed by the partners. A memorandum outlining the findings and recommendations is prepared and retained by the executive partner.
  - c. The partners determine that planned corrective actions were taken.

## Sample Quality Control Document for a Four-Partner Local CPA Firm (Profile Firm B)

### .27 Firm Background Information

Our firm has four partners, nine professional staff, and four clerical staff—a total of seventeen people. One partner has been designated as the executive partner and another as administrative partner. (A copy of our organization chart follows on the next page.)

Our executive partner founded the firm in 1953, and our growth has been derived entirely from internal expansion. All of the other partners joined the firm as staff assistants and were promoted to partner level.

Our objective is to provide quality accounting, auditing, tax, and management advisory services to our clients.<sup>1</sup> To this end we expect to limit our practice to those clients we can properly serve. We intend to further develop expertise that will enable us to increase the number of clients that are municipalities and savings and loan associations. Therefore, we plan to hire and train professional personnel who will be able to function to meet these goals.

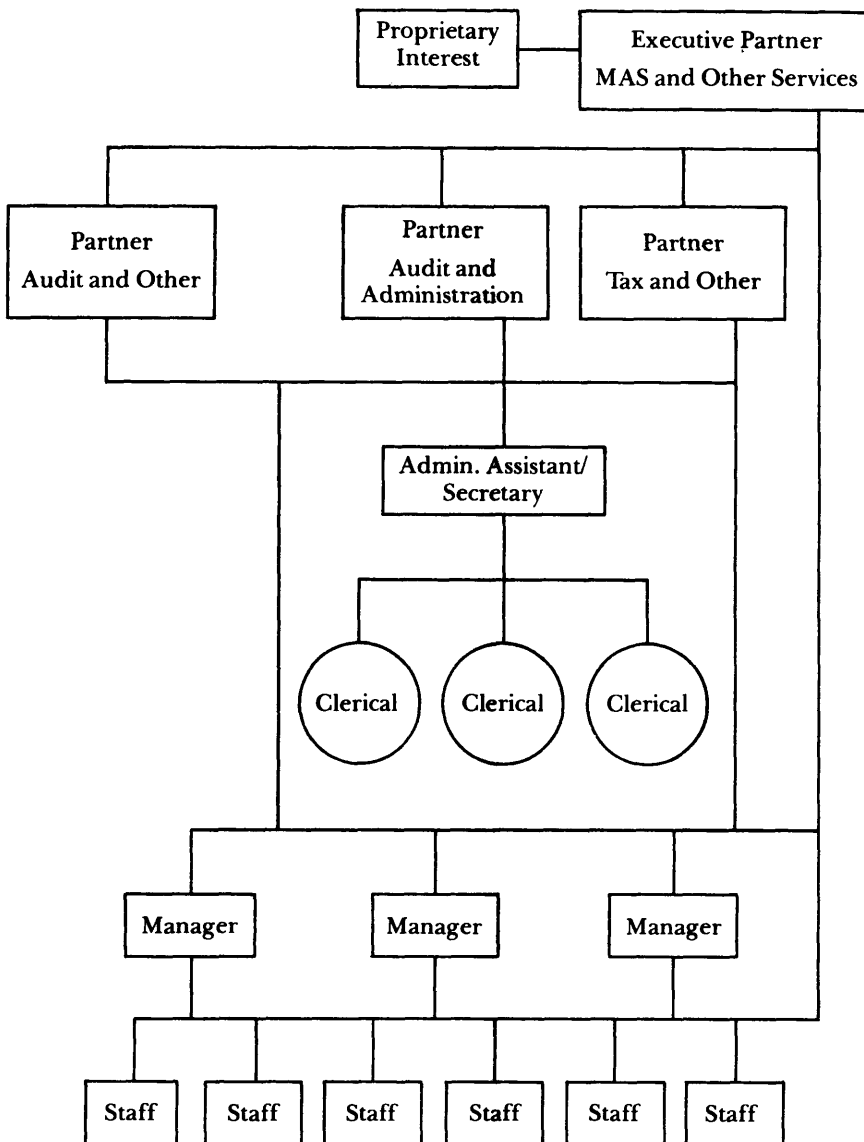
We expect our growth to continue to be internal and to be limited to our present geographic practice area; a community we have served for nearly 25 years. We hope to retain our local identity and personal relationship with clients that are the foundations of our practice.

We hope to be a firm that is enjoyable and rewarding to work for. We intend to continue our involvement in and contribution to community and professional activities and organizations.

Total man hours expended during the fiscal year ended June 30, 1977, are broken down by the following categories:

Auditing	7,100
Unaudited financial statements	5,400
Taxes	5,400
Management advisory services	2,100
Other accounting services	2,300
	<u>22,300</u>

<sup>1</sup> The objectives stated herein are adapted from the *MAP Handbook*. Additional considerations for establishing a firm's stated objectives are discussed in Appendix B.

**Organization Chart  
Firm B**

Reprinted from *Management of an Accounting Practice Handbook* (New York: AICPA, 1977),  
Section 502.06.



Our practice is conducted from one office and is basically a general practice composed of the following types of clients:

Audit engagements	
Publicly held corporations	1
Manufacturing companies	14
Retail establishments	8
Savings and loan associations	5
Municipalities	3
Unaudited statement engagements	49
Other accounting services	28

Our professional staff (excluding partners) consists of the following:

- 1 Manager with 8 years experience
- 2 Managers with 6 years experience each
- 2 In-charge accountants with 3 years experience each
- 2 Staff assistants with 2 years experience each
- 2 Staff assistants with 1 year experience each
- 1 Part-time intern

All of our full-time staff members are college graduates with a concentration in accounting. One in-charge accountant and all managers are CPAs. The other full-time staff members have passed various parts of the CPA examination.

For the benefit of our professional personnel, an accounting and auditing manual and a personnel manual are maintained. Both manuals are referred to in this document and are, in effect, an integral part of our quality control system.

November 1, 1977

## **.28 Independence**

1. All personnel are required to adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, (state) CPA Society, (state) Board of Accountancy, state statute, and for applicable engagements, the Securities and Exchange Commission and other regulatory agencies under which we practice.

- a. The executive partner is responsible for resolving questions relating to independence matters and is available to provide guidance when required.
  - b. The executive partner communicates with the AICPA and/or the (state) CPA Society for assistance in resolving independence questions that are not satisfactorily resolved within the firm.
  - c. A memo documenting the resolution of independence questions is prepared and retained by the executive partner. The other firm personnel involved in the questions review and initial the memo.
2. Policies and procedures relating to independence are communicated to all personnel.
- a. The personnel manual is used to inform personnel of the firm's independence policies and procedures and advise them that they are expected to be familiar with these policies and procedures. Rulings and interpretations of the AICPA, (state) CPA Society, (state) Board of Accountancy, state statute, the Securities and Exchange Commission and other regulatory agencies under which we practice are referred to in the personnel manual.
  - b. Independence of mental attitude is emphasized during training sessions and in the supervision and review of engagements.
  - c. Our client list, which is periodically updated, is reviewed by all partners and professional employees to ensure that they are aware of those entities to which our independence policies apply. The executive partner is responsible for maintenance and distribution of the list.
  - d. The firm's library contains professional, regulatory, and firm literature relating to independence matters.<sup>2</sup>
3. Independence is confirmed when another firm is engaged to perform a segment of an engagement for which we are the principal auditor.
- a. The form and content of the independence representation

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<sup>2</sup> The appropriate information may be found in *AICPA Professional Standards*, Vol. 2, in regulation S-X and Accounting Series Releases of the Securities and Exchange Commission, rulings and interpretations of the state CPA societies, the state boards of accountancy, and state statutes.

that is to be obtained from a firm that has been engaged to perform segments of an engagement is part of the firm's accounting and auditing manual.

- b. An annual representation of independence should be obtained from an affiliate or associate firm on a repeat engagement.
4. Compliance with policies and procedures relating to independence is monitored.
- a. Confirmations are obtained annually as of June 30 by the administrative partner from personnel and upon employment from newly hired personnel confirming that—
    - (i) They are familiar with our firm's independence policies and procedures.
    - (ii) Prohibited investments are not held and were not held during the period.
    - (iii) Prohibited relationships do not exist.
    - (iv) Transactions prohibited by the firm have not occurred.
  - b. The executive partner is responsible for the resolution of exceptions to the firm's independence policies and procedures.
  - c. The executive partner designates a partner to perform an annual review each July of the independence compliance files for completeness and the firm's independence policies and procedures for compliance with professional standards. A report of findings is presented to all the partners.
  - d. Accounts receivable that are past due are reviewed monthly by the executive partner to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

## **.29 Assigning Personnel to Engagements**

- 1. Our firm's approach to assigning personnel includes the planning of overall firm needs and the measures employed to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.
  - a. On a quarterly basis all partners submit to the administrative partner a projection containing anticipated manpower requirements for engagements during the coming quarter for which they have client responsibilities. Such projections are detailed as to number and classifications of individuals required and are supported by preliminary engagement time

estimates. The administrative partner prepares a summary schedule of assignments to be made for approval by the partners.

- b. For every engagement where the anticipated time exceeds ten man-days, a time budget is normally prepared under the direction of the engagement partner at least a month prior to the scheduled commencement of field work. Time budgets for smaller engagements are prepared as considered necessary by the engagement partners. The budgets provide detail as to appropriate staff level and time required by function such as cash, accounts receivable, inventory, and so forth.
- c. The engagement partner considers the following factors to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization:
  - (i) Engagement size and complexity
  - (ii) Personnel availability
  - (iii) Special expertise required
  - (iv) Timing of the work to be performed
  - (v) Continuity and periodic rotation of personnel
  - (vi) Opportunities for on-the-job training

**2. The administrative partner is responsible for assigning personnel to engagements.**

- a. Before the assignment of a professional employee to an engagement, the following criteria are considered:
  - (i) Staffing and timing requirements of the specific engagement.
  - (ii) Evaluations of the qualifications of personnel as to experience, position, background, and any special expertise possessed.
  - (iii) The planned extent of supervision and involvement by managers and partners.
  - (iv) Projected time availability of individuals assigned.
  - (v) Situations where possible independence problems and conflicts of interest may exist, such as assignment of personnel to engagements for clients who are former employers or employers of certain kin.
- b. The administrative partner attempts to achieve a balance between the need for continuity and for periodic rotation of personnel by every three years rotating at least one member of the engagement supervisory team (which consists of the in-charge accountant, manager, and engagement partner) off un-

audited statement engagements where engagement time exceeds ten man-days during a quarter and all audit engagements.

3. The engagement partner approves the scheduling and staffing of the engagement.
  - a. The names of personnel assigned to an engagement are submitted to the engagement partner for approval.
  - b. The engagement partner considers the experience and training of the assigned personnel in relation to complexity or other engagement requirements, and the extent of supervision to be provided.
  - c. Unresolved assignment conflicts between an engagement partner and the administrative partner are resolved by the executive partner.

### **.30 Consultation**

1. Areas and specialized situations where consultation is required are identified, and personnel are encouraged to consult with or use authoritative sources on complex or unusual matters.
  - a. All personnel are advised of our firm's consultation policies and procedures. These policies and procedures are incorporated into the firm's accounting and auditing manual.
  - b. A listing of certain areas or specialized situations, which because of the nature or complexity of the subject have been identified as requiring consultation, is updated semiannually by the administrative partner for inclusion in the accounting and auditing manual. The following areas and situations receive special consideration in preparing the list:
    - (i) Application of newly issued technical pronouncements.
    - (ii) Industries with special accounting, auditing, or reporting requirements.
    - (iii) Emerging practice problems.
    - (iv) Choices among alternative generally accepted accounting principles when an accounting change is to be made.
    - (v) Filing requirements of regulatory agencies.
  - c. A technical reference library is maintained to assist personnel in resolving practice problems. The administrative partner is charged with the responsibility of reviewing semiannually the library contents and making necessary additions.
  - d. Supervisory personnel are encouraged to seek advice from partners and managers the firm has designated as specialists

in particular areas when confronted with a situation in the specialist's area of expertise.

- e. When expertise is not available within the firm, a practice question or problem is referred by the engagement partner to a division or group in the AICPA or the (state) CPA Society established to handle technical inquiries.
  - f. We maintain a consultation agreement with the local office of (firm name) CPAs to provide our firm with additional expertise. Inquiries to that firm are channeled through the administrative partner.
  - g. The results of outside consultation are reviewed by the engagement partner and the executive partner before a decision is reached on the matter in question.
2. Specific individuals are designated as having specialized experience and expertise in certain technical areas. These individuals are available for consultation to all personnel.
- a. A listing of firm designated specialists together with their particular expertise is updated semiannually and included in the accounting and auditing manual.
  - b. The following procedures are used to resolve differences of opinion on practice problems:
    - (i) Differences of opinion between a professional employee and an engagement partner are brought before the appropriate designated specialist.
    - (ii) If the specialist agrees with the engagement partner, the matter is considered resolved.
    - (iii) If the specialist disagrees with the engagement partner and they are unable to agree on an appropriate resolution, the executive partner is consulted.
  - c. The engagement partner is responsible for the preparation of a memorandum documenting the considerations involved in the resolution of differences of opinion. The original of the memorandum is filed with the engagement working papers and a reference copy without identification of the client is placed in the subject file maintained in the library. Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.
3. In situations where firm policy requires consultation with specialists, a summary of the consultation conclusions and the reasons for the conclusions is required.

- a. The accounting and auditing manual is used to inform personnel of the extent of documentation required and the responsibility for its preparation.
- b. Consultation summaries are filed with the engagement working papers, and a copy is placed in the subject file maintained in the library under the supervision of the administrative partner. The subject file is maintained in the event that similar questions arise in connection with the same topics.

### **.31 Supervision**

1. All engagements are adequately planned by persons knowledgeable about the client and/or the type of engagement.
  - a. For all annual recurring engagements where the anticipated manpower requirement is in excess of ten man-days, the in-charge accountant or manager reviews with the engagement partner the following documents from the prior year's files (as applicable) to determine if modifications are appropriate:
    - (i) Engagement letter
    - (ii) Time budget compared with actual time expended
    - (iii) Evaluation of the system of internal control
    - (iv) Audit or work program
    - (v) Engagement memorandums
    - (vi) Financial statements and accountant's report
    - (vii) Management letters
  - b. On all engagements in excess of ten man-days, including annual recurring engagements, new engagements, and special engagements, the in-charge accountant or manager submits to the engagement partner the following, where applicable, for his written approval:
    - (i) Engagement letter.
    - (ii) Time budget.
    - (iii) Preliminary evaluation of the system of internal control.
    - (iv) Audit or work program.
    - (v) A memorandum stating the manpower requirements (including the need for specialized knowledge), current economic conditions affecting the client or its industry, and any other special problems that may have an impact on the conduct of the engagement.
2. Procedures are provided for maintaining the firm's standards of quality for the work performed.

- a. Depending upon each individual's background in relationship to his assignment, varying degrees of supervision are provided by proper engagement staffing.
  - b. Each staff member receives an accounting and auditing manual upon joining the firm and is responsible for the proper filing of updates as they are issued. This manual contains examples of properly completed working papers and copies of standardized forms, checklists, and questionnaires.
  - c. Differences of opinion among staff members working on an engagement are brought to the attention of the engagement partner. If the partner agrees with the senior party in the dispute, the matter is considered resolved. If no resolution is made, the executive partner is consulted. Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.
- 3. All engagement working papers and reports are reviewed by appropriate supervisory personnel prior to issuance of the report.**
- a. The in-charge accountant and/or manager reviews and initials all working papers he did not prepare (including those prepared by a partner). The engagement partner reviews the overall engagement (initialing all working papers not reviewed by a manager and working papers dealing with difficult and complex subjects) including financial statements and accountant's report, and discusses with the in-charge accountant or manager any critical audit areas and unusual accounting matters encountered during the course of the engagement. This discussion is documented by a memorandum when appropriate.
  - b. In certain circumstances (as enumerated at paragraph .35 item 1(d)) prior to the issuance of the financial statements and the auditor's report thereon, a second partner not otherwise associated with the engagement evaluates the appropriateness of financial statement disclosures and the auditor's report in relation to the material discussed in the engagement partner's memorandum.

## **.32 Hiring**

- 1. The firm maintains a program designed to obtain qualified personnel by planning for personnel needs, establishing hiring**



objectives, and setting qualifications for those involved in the hiring function.

- a. The administrative partner and the executive partner plan (at least annually) the firm's long-range personnel objectives. Current clientele, anticipated growth, personnel turnover, individual advancement, and retirement are among the factors considered. This plan considers the number and qualifications of personnel as well as the sources and methods for obtaining personnel who meet the requirements and guidelines set by the firm.
- b. The administrative partner is responsible for employment decisions.
2. Our firm has established qualifications and guidelines for evaluating potential hirees at each professional level.
  - a. Our firm seeks to employ individuals who possess high levels of intelligence, integrity, honesty, motivation, and aptitude for the profession.
  - b. Our firm normally employs college graduates with a concentration in accounting as full-time permanent members of our professional staff.
  - c. Newly employed staff members are from the top half of their college class, unless other factors such as personal achievements, work experience, and personal interests indicate the likelihood of adequate professional development.
  - d. Our firm requires that an applicant's academic preparation will enable him to take the CPA examination as administered by the (state) Board of Accountancy.
  - e. The approval of the executive partner is required before making an employment offer in atypical situations, such as hiring relatives of personnel or clients, rehiring former employees, or hiring clients' employees.
  - f. The background of new employees is appropriately investigated to reasonably assure hiring persons with acceptable qualifications, by obtaining completed application forms, college transcripts, and personal references.
  - g. Applicants for positions above entry level are interviewed and approved by the executive partner in addition to the administrative partner before an employment decision is made.
3. Applicants and new personnel are informed of the firm's policies and procedures relevant to them.

- a. The firm's personnel policies and procedures relevant to applicants are communicated to them before offers of employment are extended.
- b. The administrative partner maintains and distributes to all personnel a personnel manual describing policies and procedures.
- c. The administrative partner discusses the firm's personnel policies and procedures with new employees.

### **.33 Professional Development**

1. Guidelines and requirements have been established for the firm's professional development program and are communicated to all personnel.
  - a. The administrative partner is responsible for the formulation and implementation of firm policy regarding the guidelines and requirements for the firm's professional development programs.
  - b. As part of their orientation, newly employed personnel are informed of their professional responsibilities and opportunities by the administrative partner.
  - c. Newly employed personnel with limited experience are sent to introductory level training sessions of the AICPA or the (state) CPA Society during their first year of employment with our firm.
  - d. Each partner and professional employee is required to complete a minimum of 40 hours of continuing professional education each year. Personnel complete the record of professional development form and forward it to the administrative partner. The administrative partner is responsible for having the personnel files of each partner and professional employee updated to include a current record of hours of professional development completed. The types of programs qualifying for the fulfillment of the 40-hour requirement include—
    - (i) Continuing professional education programs of the AICPA and the (state) Society. This includes both sessions attended and cassette/workbook or workbook programs, as long as there is written evidence of completion.
    - (ii) College courses related to the profession.

- e. Personnel are reimbursed for membership dues paid to the AICPA, the (state) Society of CPAs and our local chapter of the state society.
  - f. Personnel are encouraged to serve on state society or AICPA committees, write articles for professional publications, serve as discussion leaders at professional development seminars, give speeches, and so forth.
  - g. The executive partner annually reviews the firm's professional development program (including personnel participation records) to determine whether it is adequately meeting the firm's needs, providing for the professional growth of individuals, and meeting mandatory continuing education requirements. An annual report is made to the partners.
- 2. Information about current developments in professional technical standards and materials containing the firm's technical policies and procedures are made available to personnel. Personnel are encouraged to engage in self-development activities.**
- a. It is the responsibility of the administrative partner to distribute statements about current developments in accounting and auditing to all personnel who do not receive them directly. This distribution includes statements and interpretations issued by the Financial Accounting Standards Board and by the AICPA Auditing Standards Executive Committee, and so forth.
  - b. Pronouncements relating to areas of specific interest, such as those issued by the Securities and Exchange Commission, Internal Revenue Service, and other regulatory agencies are distributed by the appropriate specialist to persons who have responsibilities in such areas.
  - c. The administrative partner, as the firm's lead technician, is responsible for maintaining an accounting and auditing manual containing firm policies and procedures on technical matters. Updates are prepared and issued to the staff as new developments and conditions arise.
  - d. The firm does not, at present, conduct formal in-house training programs other than in specialized areas. However, from time to time personnel participate in the training programs of (firm name) CPAs.
  - e. A library of staff training cassette/workbook programs published by the AICPA and (state) Society of CPAs is maintained

by the administrative partner for self-study and reference purposes and is available to all personnel.

3. The firm provides programs to fill its needs for personnel with expertise in specialized areas and industries.
  - a. The administrative partner is responsible for arranging in-house programs on SEC matters, cost accounting, municipal accounting, and savings and loan auditing for personnel involved in these areas.
  - b. Individuals designated as having specialized experience and expertise are encouraged to maintain their proficiency by joining appropriate professional associations and attending external professional education programs.
  - c. The firm will pay for memberships in organizations concerned with specialized areas or industries in which the firm is engaged or intends to become engaged.
  - d. The administrative partner is responsible for maintaining technical literature on specialized areas and industries.
4. The firm recognizes that on-the-job training accounts for a significant part of professional development.
  - a. Personnel with in-charge responsibility on engagements—
    - (i) Discuss with assistants the relationship of the work they are performing to the engagement as a whole.
    - (ii) Permit assistants, when practicable, to become involved in areas of the engagement other than those previously assigned.
    - (iii) Explain to assistants the reasons for any additional work requirements discovered through the review process.
  - b. Personnel are evaluated in part on their effectiveness to properly train and develop subordinates.
  - c. The administrative partner monitors assignments to determine that personnel are—
    - (i) Fulfilling, where applicable, the experience requirement of the (state) Board of Accountancy.
    - (ii) Gaining experience in various areas of engagements and varied industries.
    - (iii) Working under different supervisory personnel.

### **.34 Advancement**

1. Our firm has established qualifications deemed necessary for the various levels of responsibility within the firm.
  - a. The levels of responsibility that are inherent in the various staff classifications are clearly defined. Our firm has provided for the following staff classifications.<sup>3</sup>
    - (i) Manager
    - (ii) In-charge accountant
    - (iii) Staff assistant
  - b. The criteria which are considered in evaluating individual performance and expected proficiency are enumerated in our staff classification guidelines contained in the personnel manual.
  - c. Our firm's personnel manual provides the staff with information regarding the firm's advancement policies and procedures. The administrative partner issues updates from time to time to reflect changes made by the partnership in the policies and procedures.
2. The performance of our personnel is continuously evaluated, and personnel are periodically advised of their progress. Personnel files are maintained containing documentation relating to the evaluation process.
  - a. Professional employees assigned to an engagement for a period in excess of five days must be evaluated by their immediate superior on the engagement by use of an evaluation form. These evaluation forms are reviewed with the employee at the end of the engagement and are approved by the engagement partner.
  - b. Personnel are assigned to engagements in a manner that assures they will be reviewed by several people during the course of a year.
  - c. Personnel with the responsibility for the preparation of evaluations are counseled (at least annually) by the administrative partner to ensure that they understand the firm's objectives.

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<sup>3</sup> The description of the firm's professional levels, with the responsibilities for each level and the general length of time required for advancement to the next position, is attached as Appendix A.

- d. All professional employees receive an evaluation of their performance at least once a year. Such counseling interviews are conducted by the administrative partner. These evaluations summarize the evaluations received on engagements during the year. The individual's progress, strengths, weaknesses, future objectives, and the firm's future objectives are among the items discussed. The interviews are documented in each individual's personnel file.
- e. Annually, each partner completes a partner evaluation form evaluating each of the partners, including himself. The completed forms are submitted to the executive partner who summarizes and reviews them with each partner.
- f. The executive partner or his designee reviews (each August) the system of personnel evaluation and counseling to ascertain that—
  - (i) Procedures for evaluation and documentation are being followed on a timely basis.
  - (ii) Requirements established for advancement are being met.
  - (iii) Personnel decisions are consistent with evaluations.
  - (iv) Recognition is given to outstanding performance.At the completion of the review, a report is made to the partners.

**3. Responsibility for making advancement decisions is assigned to specific individuals.**

- a. The administrative partner is responsible for making advancement and termination recommendations, conducting the evaluation interviews, documenting the results of the interviews, and maintaining appropriate records.
- b. The partners evaluate the above data and, after giving appropriate recognition to the quality of the work performed, make advancement decisions. The executive partner has the ultimate responsibility for making advancement decisions.
- c. The executive partner studies the firm's advancement experience annually to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. A report is made to the partners. This report includes the executive partner's opinion of the capabilities and progress of the staff.

### **.35 Acceptance and Continuance of Clients**

- 1. Our firm has established procedures for evaluation of prospective clients and for their acceptance as clients.**
  - a. Available financial information regarding the prospective client, such as annual reports, interim financial statements, reports to regulatory agencies, and income tax returns is obtained and reviewed. Registration statements and 10-K forms are obtained for public companies.
  - b. Inquiries about potential clients are made to bankers, attorneys, credit services, and others having business relationships with the company.
  - c. Predecessor auditors (if applicable) are contacted and inquiries are made in accordance with generally accepted auditing standards.
  - d. Consideration is given to circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks. These circumstances include—
    - (i) Audits of publicly held corporations.
    - (ii) Audits where the annual fee is expected to exceed \$10,000 or where the expected man-hour requirement exceeds 300 hours.
    - (iii) Audits of firms operating in high-risk industries, such as those industries where it is difficult to establish adequate systems of internal control or those industries whose operations are especially sensitive to general economic conditions.
    - (iv) Audits of firms in the development stage.
    - (v) Audits of firms in serious financial difficulty.
    - (vi) Any of the conditions enumerated in 2(a)(iii).
  - e. The firm's independence and ability to adequately serve a potential client are evaluated prior to acceptance. In evaluating the firm's ability, consideration is given to the requirements for technical skills, knowledge of the industry, and availability of qualified personnel.
  - f. A review is made to ensure that acceptance of the client would not violate applicable regulatory agency requirements and the codes of professional ethics of the AICPA and/or the (state) CPA Society.
  - g. Procedures for acceptance of a new engagement are as follows:

- (i) The engagement partner assembles the information and evaluates all matters described in the previous paragraphs.
    - (ii) For all audit engagements, or engagements described in paragraph (d) above, the acceptance is to be approved in writing by the engagement partner and the executive partner.
    - (iii) All other engagements are to be approved in writing by the engagement partner and the administrative partner.
  - h. The administrative partner is responsible for administering the procedures for acceptance of clients. The executive partner performs an annual review for compliance with the firm's policies and procedures for acceptance of clients and makes a report to the partners.
2. Clients are evaluated at the end of specific periods or upon the occurrence of certain events to determine whether the relationship should be continued.
- a. Reevaluations are made of existing clients—
    - (i) Annually, if any of the conditions mentioned in 1(d) exist.
    - (ii) Every three years if none of the conditions mentioned in 1(d) exist.
    - (iii) If there is a significant change in one or more of the following:
      - Management
      - Directors
      - Ownership
      - Legal counsel
      - Financial condition
      - Litigation status
      - Nature of client's business
      - Scope of the auditor's work
    - (iv) Upon the emergence of conditions that would have caused the firm to reject a client had such conditions existed at the time of the initial acceptance.
  - b. The administrative partner is responsible for evaluating the information obtained, making continuance recommendations, and administering firm procedures for continuance of clients. If the administrative partner recommends discontinuance or if any of the conditions enumerated in 2(a)(iii) or (iv) exist, all partners participate in the continuance decision.



- c. The executive partner performs an annual review to test for compliance with the firm's policies and procedures for continuance of clients and makes a report to the partners.

### **.36 Inspection**

1. The firm conducts an inspection program regarding its quality control policies and procedures.
  - a. Each year a partner and a manager not otherwise directly involved in firm administration are appointed by the executive partner as an inspection team to evaluate the firm's quality control policies and procedures for compliance with professional standards.
  - b. The appointed partner and manager obtain reasonable assurance that quality control policies and procedures are being complied with by—
    - (i) Inquiring of persons responsible for a function or activity.
    - (ii) Reviewing selected administrative and personnel files.
    - (iii) Reviewing selected engagement working paper files and reports (described below).
    - (iv) Reviewing other evidential matter.
  - c. A sample of engagements is selected annually from each partner's and manager's client listing and is given an in-depth review by the inspection team. The administrative partner reviews engagements of the partner and manager involved in the inspection process to ensure that a representative sample of engagements from all partners and managers has been selected. The working papers and reports are reviewed for compliance with professional standards, including generally accepted auditing standards, generally accepted accounting principles, and the firm's quality control policies and procedures.
  - d. The executive partner annually selects a representative report to be submitted for review to the practice review committee of the (state) Society and/or the AICPA.
  - e. Every third year the firm undergoes an AICPA quality control compliance review. The executive partner is responsible for scheduling the review and ensuring that all partners participate in the knowledge gained by the reviews.
2. Provision is made for reporting inspection findings to the appropriate management levels and for monitoring actions taken or planned.

- a. The results of engagement reviews are discussed with the supervisory personnel responsible for the engagement.
- b. Inspection findings and recommendations are reported to the partners by the inspection team together with corrective actions taken or planned. A memo outlining the findings and recommendations is prepared by the inspection team and is retained by the executive partner.
- c. The executive partner has the responsibility to determine that planned corrective actions were taken and to report the extent of compliance to all the partners.

## APPENDIX A

**.37 Description of the Firms' Professional Levels**Profile Firm A

<u>Level</u>	<u>Approximate Time Frame</u>
Staff Assistant	
Level 1	First year (0 to 1)
Level 2	Second and third year (2 to 3)
In-charge accountant	Fourth through eighth year (4 to 8)
Partner	After the eighth year

*Staff Assistant (Level 1).* A Level 1 staff assistant is expected to—

- Work on portions of audit and accounting engagements.
- Become familiar with the firm's policies and procedures.
- Know the rules, regulations, and code of ethics of the AICPA and the (state) Society of CPAs.
- Be familiar with pronouncements of the Financial Accounting Standards Board (FASB) and the AICPA, such as the statements on auditing standards (SASs) and Accounting Principles Board opinions (APBs).
- Progress professionally by working toward passing the CPA examination as soon as possible.

*Staff Assistant (Level 2).* A Level 2 staff assistant should be able to—

- Assume full responsibility under supervision for small accounting engagements involving unaudited financial statements.
- Work on more involved portions of large audit and accounting engagements.
- Prepare financial statements.

*In-charge Accountant.* An in-charge accountant is expected to—

- Assume full responsibility for small and medium-size audit engagements requiring the services of one or two people and large accounting engagements involving unaudited financial statements.
- Work on (and research) assignments involving “theory” and such “conceptual” areas as materiality and interrelationships of accounts.

- Review and analyze internal control.
- Prepare audit programs and time budgets.
- Be responsible for compliance with due dates and adherence to time budgets.
- Prepare management letters.
- Train and supervise the staff members assigned to the engagement.
- Recognize, in advance, the possible problem areas of an engagement.
- Pass the CPA examination, if not already certified.

### Profile Firm B

<u>Level</u>	<u>Approximate Time Frame</u>
Staff Assistant	
Level 1	First year (0 to 1)
Level 2	Second year (1 to 2)
In-charge accountant	Third, fourth, fifth (3 to 5)
Audit manager	Sixth through tenth year (6 to 10)
Partner	After the tenth year

*Staff Assistant (Level 1).* A Level 1 staff assistant is expected to—

- Work on portions of audit and accounting engagements.
- Become familiar with the contents of the firm manuals.
- Know the rules, regulations, and code of ethics of the AICPA and the (state) Society of CPAs.
- Be familiar with the pronouncements of the Financial Accounting Standards Board (FASB) and the AICPA, such as the statements on auditing standards (SASs) and Accounting Principles Board opinions (APBs).
- Progress professionally by working toward passing the CPA examination as soon as possible.

*Staff Assistant (Level 2).* A Level 2 staff assistant should be able to—

- Assume full responsibility under supervision for small accounting engagements involving unaudited financial statements.
- Work on more involved portions of large audit and accounting engagements.
- Prepare financial statements.

*In-charge Accountant.* An in-charge accountant is expected to—

- Assume full responsibility for small and medium-size audit en-

gements requiring the services of one or two people and large accounting engagements involving unaudited financial statements.

- Work on (and research) assignments involving “theory” and such “conceptual” areas as materiality and interrelationships of accounts.
- Review and analyze internal control.
- Prepare audit programs and time budgets.
- Prepare management letters.
- Train and supervise the staff assistants assigned to the engagement.
- Recognize, in advance, the possible problem areas of an engagement.
- Pass the CPA examination, if not already certified.

*Manager.* A manager is a CPA and is expected to—

- Assume full responsibility for large audit assignments falling within his expertise.
- Supervise the assignment of duties to, and the training of, personnel assigned to the engagement.
- Supervise a number of engagements at one time.
- In connection with engagements, be responsible for personnel scheduling, compliance with due dates, and monitoring time budgets.
- Adequately review all working papers and the completed reports to ascertain that both meet firm standards.
- Resolve all problems prior to the submission of the report for final partner review.
- Communicate firm policies and technical information to accounting and auditing personnel through individual or group meetings.
- Motivate and assist staff in their professional development.
- Represent the firm in professional and service organizations.
- Develop the firm’s reputation and his own through conducting seminars, making speeches, and the like.
- Assist partners with practice development and practice management.

## APPENDIX B

**.38 Stated Objectives of Firm  
(Philosophy)**

A particular firm's stated objectives may include items such as the following:

1. Concern for the general public interest.
2. Concern for the financial well-being of clients.
3. Reinvestment of the firm's profits in the training and advancement of the firm's partners and staff.
4. Growth plans for the firm, including opening of branch offices, annual billings, and staff size.
5. Development of specialties such as auditing governmental units or concentration in particular fields—banks, agriculture, retail, and so forth.
6. Development of other services, such as a computer data processing center.
7. Centralization (or decentralization) of authority for issuance of reports.
8. Degree of operating autonomy for individual practice offices.
9. Extent of autonomy for partners.
10. Pattern for firm growth—internal growth through acquisitions of clients and growing apace with them or growth through mergers with other accounting firms.

## APPENDIX C

**.39 References to Management of an Accounting Practice Handbook**

The *Management of an Accounting Practice Handbook* contains many forms and questionnaires that may facilitate a firm's implementation of its quality control document. The following list provides references to various exhibits of the *MAP Handbook* (as updated through October 1977) as they relate to the elements of quality control. Some of the exhibits could be utilized intact, while others will require modification for application to a firm's quality control document.

	<u>Reference</u>
<b>Assigning Personnel to Engagements</b>	
Preliminary Monthly Staff Schedule	205-5
Final Monthly Staff Schedule	205-6
Final Monthly Staff Schedule	205-7
Time Budget	205-8
Audit Time Budget	205-8-1
Audit Time Budget	205-9
Audit Time Analysis (Short Form)	205-10
Audit Time Analysis (Long Form)	205-11
Weekly Progress Report	205-12
Engagement Status Report	205-12-1
Partner's Annual Schedule by Client	205-46
Partner's Monthly Schedule by Client	205-47
Staff Member's Annual Schedule by Client	205-48
Staff Member's Monthly Schedule by Client	205-49
Carry-Forward Status Report	205-50
Schedule Recap Sheet	205-51
Scheduling Master Plan	205-52
Firm Annual Schedule Summary for Year	205-53
<b>Consultation</b>	
Industry Competency Questionnaire	305-4
A Suggested Firm Library	505
<b>Supervision</b>	
Report Guide Sheet	206-1
Standard Office Review Program	206-3

**Hiring**

Test of Work Force Requirements—Audit Staff	201-6
Forecast of Staff Levels for Planning and Recruiting	201-13
Recruiting Brochures	302-04
Recruitment Letter	302-2
Interview Evaluation	302-3
Professional Employment Application	302-10
Personnel Guide	A3-00

**Professional Development**

Orientation Checklist	305-1
Record of Professional Development	306-1

**Advancement**

Knowledge and Skill Form	307-1-2
Final Review—Joint Summary Form	307-1-3
Assignment Performance Evaluation Questionnaire	307-1-4
Evaluation Report on Managers, Supervisors, and Specialists	307-2
Performance Evaluation-Audit	307-3
Performance Evaluation—Management Group	307-5
Supervisor Evaluation Report	307-6
Partner and Principal Self-Evaluation Form	407-1
Evaluation Analysis for Partners	407-2

**Acceptance and Continuance of Clients**

Client Review	105-1
New Client Report	204-36
Client Data Sheet	204-37-1



