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TECHNICAL PRACTICE AIDS

TECHNICAL INFORMATION SERVICE
INQUIRIES AND REPLIES

STATEMENTS OF POSITION
ACCOUNTING STANDARDS DIVISION
AUDITING STANDARDS DIVISION

ISSUES PAPERS
ACCOUNTING STANDARDS DIVISION

QUALITY CONTROL

AS OF JUNE 1, 1983

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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AS OF JUNE 1, 1983

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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, Statements of Position of the Auditing Standards Division, a list of Issues Papers of the Accounting Standards Division, and guidance material related to the Voluntary Quality Control Review Program for CPA Firms issued by the American Institute of Certified Public Accountants.

How This Volume is Arranged . . .

The contents of this volume are arranged as follows:

Technical Information Service Inquiries and Replies

Introduction

Financial Statement Presentation

Assets

Liabilities and Deferred Credits

Capital

Revenue and Expense

Specialized Industry Problems

Specialized Organizational Problems

Audit Field Work

Auditors' Reports

Statements of Position of the Accounting Standards Division

Statements of Position of the Auditing Standards Division

Issues Papers of the Accounting Standards Division

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 of the Accounting Standards Division are assigned section numbers in chronological order as they are issued. Each paragraph or equivalent is decimally numbered for reference purposes.

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

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

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

The quality control review program includes sample quality control documents for local CPA firms and sole practitioner CPA firms.

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 replies, whether written or oral, and to the material in this section:

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

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 non-current. 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.

.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.

.08 Classification of Outstanding Checks

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

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

➡ *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.

»»→ *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:	<u> </u>	(xx)
Increase (Decrease) in Funds		<u> </u>

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?

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

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

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

Reply—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.

.10 Comprehensive Basis of Accounting Other than Generally Accepted Accounting Principles

Inquiry—When an entity prepares its financial statements on a comprehensive basis of accounting other than generally accepted accounting principles, is a Statement of Changes in Financial Position required?

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

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

SAS No. 14, paragraph 7 states in part:

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

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

➡ *The next page is 261.* ←

Section 1400

Consolidated Financial Statements

.01 Operations of Subsidiaries and Parent Closely Related

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

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

.02 Consolidation of Corporation and Proprietorship

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

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

As in any consolidation, the stockholders' equity of the subsidiary corporation should be eliminated against the investment

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

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

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

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

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

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

.06 Combined and Separate Financial Statements

Inquiry—Company A and Company B are new car dealers with A selling an American made car and B selling a foreign

made car. One individual owns 100% of the outstanding stock of both companies.

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

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

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

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

Reply—Paragraph 22 of Accounting Research Bulletin No. 51 states in part:

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

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

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

be required—e.g., if the losses of either company have been so severe that an insolvent condition might be anticipated.

.07 Reporting on Company Where Option to Acquire Control Exists

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

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

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

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

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

.08 Intercompany Profits in Inventories

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

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

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

ARB No. 51, paragraph 6, includes the following statement:

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

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—ARB No. 51, paragraph 6, requires elimination of intercompany profits in the preparation of consolidated statements. APB Opinion No. 18, paragraph 19a, 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.

.13 Presentation of Investment in Partnership

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

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

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

Reply—Since the company “owns” 70% of the limited partnership, the financial statements of the limited partnership would be combined with those of the company on a line by line basis even though during the first nine years there would be a minority interest in earnings of 70%. If the company decides to issue only its own financial statements to the stockholders as “the financial statements of the primary reporting entity,” then the equity method described in APB Opinion No. 18 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. APB 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 where the consolidation is otherwise appropriate.”

Unless the financial statements of corporation B are being prepared for a special purpose for which recognition of equity in its subsidiaries is not appropriate, any failure to consolidate or carry at equity basis its interests in corporations C and D should be considered a departure from generally accepted accounting principles.

.15 Temporary Loss of Control of Subsidiary

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

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

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

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

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

.17 Caption of Notes to Financial Statements

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

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

.18 Combined Statements for Corporation and Partnership Commonly Owned

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

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

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

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

To justify the preparation of consolidated statements, the controlling financial interest should rest directly or indirectly in one of the companies included in the consolidation. There are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations. Combined statements would also be used to present the financial position and the results of operations of a group of unconsolidated subsidiaries. They might also be used to combine the financial statements of companies under common management.

.19 Consolidation of Limited Partnerships

Inquiry—Company A, a privately held real estate developer and operator, conducts a portion of its business through limited partnerships in which it is a general partner. The limited partnerships are structured so that Company A, the general partner, has a 5% interest in profits and losses, shares in two-thirds of the cash flow from operations after the limited partners receive their guaranteed payments, and has full authority to operate, manage, refinance, and sell. Should Company A consolidate the limited partnerships?

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

.20 Fiscal Years for Tax and Financial Reporting Purposes Differ

Inquiry—Can an entity have different fiscal years for tax and reporting purposes?

Reply—There is no requirement in the accounting literature for the tax and the financial reporting year end to be the same. However, having different fiscal years complicates further any interperiod tax allocation the entity may have.

➤ *The next page is 301.* ←

Section 1500

Cash Basis Statements or Modifications Having Substantial Support

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

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

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

.04 Terminology for Cash Basis Financial Statements

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

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

.05 Substantial Support for Modifications in Cash Basis

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

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

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

Modifications of the cash basis of accounting to record depreciation on plant and equipment and to accrue income taxes were recognized in SAS No. 14. Ordinarily a modification would have “substantial support” if the method is equivalent to the accrual basis of accounting for the particular item and if the method is not illogical (such as, recording revenue on the accrual basis and recording purchases and other costs on the cash basis). If modifications to the cash basis of accounting do not have substantial support, the auditor should include in his report an explanatory paragraph and modify the recommended language.

If the modifications are so extensive that the modified “cash-basis” statements are, in the auditor’s judgment, tantamount to financial statements on the accrual basis, the statements should be considered accrual basis. The auditor should use the standard form of report (SAS No. 2, paragraph 7), modified as appropriate because of departures from generally accepted accounting principles (SAS No. 2, paragraphs 15 through 17). For example, financial statements that are presented in conformity with generally accepted accounting principles, except that material leases are not capitalized (FASB Statement No. 13), are not considered “modified cash-basis” financial statements.

➤→ *The next page is 451.* ←➤

Section 1600

Personal Financial Statements

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

Inquiry—Does FASB Statement No. 12 apply to personal holding companies?

Reply—Yes. Paragraph 5 of the Statement lists the entities to which the Statement does not apply.

TIS Section 2000

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.05 Reporting Write-off of Unamortized Goodwill

➤ The next page is 721. ←

Section 2110

Cash

.01 Depositing Cash Receipts

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

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

.02 Checks Undelivered at Balance Sheet Date

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

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

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

.03 Drafts Outstanding as Reductions of Cash Balance

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

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

.04 Bank Account of Debtor Held by Creditor

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

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

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

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

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

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

»→ *The next page is 761.* ←«

Section 2120

Temporary Investments

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

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

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

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

How should this commitment be presented in the financial statements?

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

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

.02 Leveling Gains and Losses of Pension Trust

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

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

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

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

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

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

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

.03 Presentation of Cash and Temporary Investments

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

Reply—Neither of the described presentations is acceptable. FASB Statement 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.

»»»→ *The next page is 811.* ←«««

Section 2130

Receivables

.01 Accrued Interest Revenue on Doubtful Receivables

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

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

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

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

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

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

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

.03 Recoverable Customs Duties

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

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

What is the proper treatment for such recoverable duties?

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

.04 Disclosure of Receivables 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.

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.

»»»→ *The next page is 861.* ←«««

Section 2140

Inventories

.01 Warehousing Included in Cost of Inventory

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

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

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

The discussion includes the following:

Selling expenses constitute no part of the inventory costs.

To the extent that warehousing is a necessary function of importing merchandise before it can be sold, certain elements of warehousing cost might be considered an appropriate cost of inventory in the warehouse. For example, if goods must be brought into the warehouse before they can be made ready for sale, the cost of bringing such goods into the warehouse would be considered a cost of inventory. Similarly, if goods must be handled in the warehouse for assembly or for removal of foreign packaging, etc., it would be appropriate to include such costs in inventory. However costs involved in storing the goods for any additional period would appear to be period costs. Costs of delivering the goods from the warehouse would appear to be cost of goods sold, and should not under any circumstances be allocated to goods that are still in the warehouse.

.02 Obsolete Items in Inventory—I

Inquiry—A client purchased in bulk various inventories of stock material. This material is used to produce various specialized parts used in electronic equipment. The bulk purchase took place some eighteen months ago, and less than ten percent of these inventories have been used. The client claims that there

may be some obsolete stock on hand from this bulk purchase, but an eighteen months period is not enough time to effectively determine the complete degree of obsolescence because the highly specialized nature of the product line may not lead to renewed orders until periods beyond one or more operating cycles. Based on the information available to the client, about one-third of the original bulk purchase will be written off because of obsolescence. For the remaining inventories, the client will present a representation letter indicating that he believes the remaining inventory not to be obsolete.

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

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

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

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

.03 Obsolete Items in Inventory—II

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

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

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

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

.04 Airplanes Chartered While Held for Sale

Inquiry—A company purchases airplanes for sale to others. However, until they are sold, the company charters 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.

.11 Average Cost Method for Subsidiary

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

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

»»»→ *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.

.18 Revaluation of Assets

Inquiry—Company A acquired a material amount of treasury stock resulting in a stockholders' equity deficit. Since state law (where Company A is incorporated) prohibits the impairment of legal capital, Company A revalued certain of its assets at fair market value. Should Company A record depreciation for the revalued assets based on historical cost or fair market value?

Reply—APB Opinion No. 6, paragraph 17, states:

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

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

»»→ *The next page is 1261.* ←««

Section 2220**Long-Term Investments****.01 Equity Method When Current Direct Ownership Less Than Twenty Percent**

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

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

Reply—Paragraph 17 of Accounting Principles Board Opinion No. 18 states that the ability to exercise the type of influence contemplated in the Opinion may be indicated in several ways such as representation on the board of directors and investment (direct or indirect) of 20% or more in the voting stock of an investee.

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

.03 Equity Method for Investee Following Completed Contract Method

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

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

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

Both the completed contract method and the percentage of completion method are generally accepted, and the investor should not change the investee’s method of accounting from completed contract to percentage of completion in applying the equity method.

.05 Assuming Pro Rata Share of Venture’s Revenues and Expenses

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

Reply—Paragraph 19-c of APB Opinion No. 18 states:

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

However, Interpretation No. 2 of APB Opinion No. 18, relating to accounting for investments in unincorporated joint ventures states in part:

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

Terminology such as “should ordinarily” contained in the above reference indicates that picking up the share of the joint venture on a line by line item, while it may be unusual, would not necessarily be prohibited. Guidance for transactions of this type relating to real estate can be found in SOP 78-9, *Account-*

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

.06 Recognizing Unrealized Appreciation of Hedge Fund

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

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

.07 Equity Method for Small Business Investment Companies

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

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

The AICPA Industry Audit Guide, *Audits of Investment Companies*, includes accounting principles and financial statements for investment companies. Valuation of securities is discussed on pages 15-17 of the Guide. Investment companies should, in general, report their security investments at value. Guidance is provided on determining value. [Amended]

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

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

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

The subsidiaries are accounted for under the equity method.

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

Reply—Accounting Principles Board Opinion No. 18, paragraph 19 states in part, “The difference between consolidation and the equity method lies in the details reported in the financial statements. Thus, an investor’s net income for the period and its stockholders’ equity at the end of the period are the same whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated. . . .” Intercompany profit eliminations under the equity method is discussed in Interpretation No. 1 to Opinion 18 and states in part, “All intercompany transactions are eliminated in consolidation, but under the equity method intercompany profits or losses are normally eliminated only on assets still remaining on the books of an investor or an investee.”

Both paragraph 19 of Opinion No. 18 and Interpretation No. 1 indicate that the intercompany gain (\$150,000 and \$200,000)

recorded by the investor company would be eliminated under the equity method.

In the second case, measuring the value of the computer programs by the \$200,000 stated value of the stock may not be appropriate, and the auditor should try to satisfy himself concerning the estimated values assigned to the tangible and intangible assets contributed by the other stockholders. (See paragraph 19n of Opinion 18 and paragraph 88 of Opinion 16.)

.09 Market Value of Unregistered Stock

Inquiry—A company needs a monthly valuation of its securities at market. Among the securities to be valued are some lettered securities that contain a three-year restriction against sale. These lettered securities consist of 7½% convertible debentures maturing in five years and common stock which had to be purchased as a unit. Common stock which is unrestricted is being freely traded and is presently selling at three times the cost of the restricted common.

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

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

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

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

In determining how much credibility to assign to evidence of valuation of an asset, it is necessary to evaluate the competence

and experience of the individual appraiser, his knowledge of the field, and the individual asset involved.

.10 Elimination of Intercompany Profits

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

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

Paragraph 19 of APB Opinion No. 18 normally requires an investor's net income and stockholder's equity to be the same from application of the equity method as would result from consolidation. Because the equity method is a "one-line" consolidation, however, the details reported in the investor's financial statements under the equity method will not be the same as would be reported in consolidated financial statements (see paragraph 19-c). All intercompany transactions are eliminated in consolidation, but under the equity method intercompany profits or losses are normally eliminated only on assets still remaining on the books of an investor or an investee.

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

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

Inquiry—Corporation A owns investments ranging from 20% to more than 50% in several limited partnerships and unincorporated joint ventures. Is Corporation A required to use the equity method to account for its investments? If Corporation A uses the equity method for its investments, should the auditors of Corporation A examine the financial statements of each separate investee?

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

APB Opinion No. 18 applies only to investments in common stock of corporations and does not cover investments in partnerships and unincorporated joint ventures (also called undi-

vided interests in ventures). Many of the provisions of the Opinion would be appropriate in accounting for investments in these unincorporated entities, however, as discussed below.

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

* * *

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

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 . . .

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

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

Reply—AICPA SOP No. 78-9 recommends that the equity method be used to account for investments in corporate or non-corporate real estate ventures. APB Opinion No. 18, paragraph 19 i, states:

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

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

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

➤ *The next page is 1391.* ←

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

Section 2240

Cash Surrender Value of Life Insurance

.01 Balance Sheet Classification of Life Insurance Policy Loan

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

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

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

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

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

Note 3 to paragraph 7 of this Chapter states:

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

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

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

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

ing cycle of the business, such loan may be excluded from current liabilities. Furthermore, as the owner of a policy normally has the right to offset the loan against the proceeds received on maturity or cancellation of the policy, it is appropriate to apply the amount of the loan in reduction of the cash surrender value, with disclosure of the amount so offset.

.02 Disclosure of Life Insurance on Principal Stockholders

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

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

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

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

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

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

Inquiry—Clearly, cash surrender values of life insurance may be included among the assets in the balance sheet of an enterprise. Is this mandatory, or may management elect to omit this item from the assets on the theory that its inclusion will be misleading since the insurance is carried for the purpose of covering

the loss it is anticipated will be sustained as a result of the death of a key official?

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

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

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

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

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

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

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

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

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

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

➤→ *The next page is 1451.* ←➤

Section 2250

Intangible Assets

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

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

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

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

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

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

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

A company should evaluate the periods of amortization continually to determine whether later events and circumstances warrant revised

estimates of useful lives. If estimates are changed, the unamortized costs should be allocated to the increased or reduced number of remaining periods in the revised useful life but not to exceed forty years after acquisition.

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

It is appropriate to adjust the estimate of the period benefited by the intangible assets at the date the contingent consideration is determined. Such amortization period may not exceed forty years from the date of the original acquisition. The revised life should be applied to the unamortized balance of the originally recorded intangible, as well as to the additional payment being made, on a straight line basis in accordance with paragraph 30 of APB Opinion No. 17. If the intangibles can be broken down between general "goodwill" and other intangibles, the estimated lives for the various intangible assets may differ.

.04 Appraisal Value of Intangible Assets

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

Reply—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.”

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

.05 Reporting Write-off of Unamortized Goodwill

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

Reply—In accordance with 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 statements. Gains or losses of a similar nature that are not indi-

vidually 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.

TIS Section 3000

LIABILITIES AND DEFERRED CREDITS

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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.

➡ The next page is 2021. ←

Section 3200

Long-Term Debt

.01 Classification of Unamortized Bond Discount

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

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

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

.02 Classification of Discount on Installment Notes to Banks

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

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

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

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

.03 Discount on Chattel Mortgage

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

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

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

.04 Classification of “Add-on Interest”

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

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

.05 Classification of Indefinitely Deferred Payable

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

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

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

.06 Amortization Period for Placement Fee When Mortgage Refinanced

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

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

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

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

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

.07 Calculation of Present Value of an Annuity

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

Present value of 336 monthly payments of \$1,583.33 discounted at 8½% (interest rate on loan from Insurance Company) (\$1,583.33 plus \$1,583.33 × 127.9071)	\$204,000
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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 pay-		
ments:		
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 (8½% per year divided by twelve months per year equals 17/24% per month).

.08 Transfer of Contingently-Held Notes to Capital Surplus

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

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

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

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

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

.09 Financial Statement Presentation of “Pay Any Day” Loans

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

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

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

»»»→ *The next page is 2471.* ←«««

Section 3400

Contingent Liabilities

.01 Contested Liability

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

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

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

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

.02 Disclosure of Agreement Between Corporation and Its Shareholders

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

Reply—Corporation A should disclose the terms of the agreement in a note to its financial statements since it is a contingent liability (APB Statement No. 4, Chapter 7, paragraph 199, R 9 A).

➡ The next page is 2571. ←

Section 3500

Commitments

.01 Accounting for Contract to Cut Timber

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

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

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

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

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

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

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

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

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

Reply—The client is directly liable for the amount advanced to the foreign supplier. It appears from the description of the transactions that the foreign bank is contingently liable if the supplier does not perform under the agreement. The offsetting asset would be classified as an "Advance to Suppliers." Additional footnote disclosure of the financial arrangements would also be required.

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

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

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

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

.04 Recognition of Losses on Purchase Commitments

Inquiry—Statement 10 of Accounting Research Bulletin No. 43, Chapter 4 states: "Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts thereof separately disclosed in the income statement."

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

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

.05 Letters of Credit

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

Reply—FASB Statement No. 5, paragraphs 18-19, requires disclosure of unused letters of credit. They are commitments and should not be reported as a liability in the financial statements. [Amended]

.06 Covenants Imposed by Loan Agreements

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

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

»»→ *The next page is 2671.* ←««

Section 3600

Deferred Credits

.01 Balance Sheet Presentation of Unearned Revenue

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

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

Reply—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.

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 APB Opinion No. 30, paragraph 20. The discount of the stock, if material, should be shown as a separate item in the income statement as a “special discount granted to a customer” under APB Opinion No. 30, paragraph 26. [Amended]

.05 Restricted Stock Issued to Officer

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

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

Reply—In accordance with APB Opinion No. 25, paragraph 14, the unearned compensation should be deducted from stockholders’ equity.

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

.07 Expenses Incurred in Withdrawn Public Offering

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

Reply—ARS No. 15, “Stockholders’ Equity,” page 23, discusses accounting for stock issue costs. The Study states that such costs are usually deducted from contributed portions of equity, that is capital stock or capital in excess of stated or

par value, as a reduction in the proceeds from the sale of securities.

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

➤ *The next page is 3121.* ←

Section 4120

Reacquisition of Capital Stock

.01 Redeemed Preferred Stock Considered Dividend

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

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

.02 Corporation Buys Out Major Stockholder

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

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

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

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

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

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

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

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

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

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

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

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

➤→ *The next page is 3201.* ←➤

Section 4130

Warrants

.03 Warrants Recquired

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

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

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

➡ *The next page is 3251.* ←

Section 4140

Stock Options and Stock Purchase Plans

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

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

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

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

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

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

.02 Disclosure of Stock Option Plan Prior to Measurement Date

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

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

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

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

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

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

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

.04 Accounting for "Disqualifying Dispositions" of Stock

Inquiry—Must a company account for all "disqualifying dispositions" of shares of stock acquired pursuant to employees stock option plans during 1973 under the requirements of 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.

➤→ *The next page is 3341.* ←➤

Section 4150

Stock Dividends and Stock Splits

.01 Stock Dividends of Closely-Held Corporation

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

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

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

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

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

Reply—Since only 20% of the corporation's stock is not controlled by the board of directors, it is likely that these minority shareholders would not have intimate knowledge of the corporation's affairs, as contemplated in paragraph 12, Chapter 7, Section B of Accounting Research Bulletin No. 43, which excludes closely-held corporations from the provisions of paragraph 10.

Accordingly, the requirements of paragraph 10 would apply. The stock dividends should be capitalized at the selling price of the stock with a corresponding charge to retained earnings. [Amended]

.02 Stock Dividend Affecting Market Price of Stock

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

Reply—Paragraph 13 in Chapter 7, Section B of Accounting Research Bulletin No. 43 states, in part, “On the basis of a review of market action in the case of shares of a number of companies having relatively recent stock distributions, it would appear that there would be few instances involving the issuance of additional shares of less than, say, 20% or 25% of the number previously outstanding where the effect would not be such as to call for the procedure referred to in paragraph 10.” Paragraph 10 requires a transfer from retained earnings to the category of permanent capitalization in an amount equal to the fair value of the additional shares issued.

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

.03 Stock Dividends Without Determinable Market Value

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

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

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

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

»»»→ *The next page is 3401.* ←«««

Section 4160

Contributed Capital

.01 Payment of Corporate Debt by Stockholders

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

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

➤→ *The next page is 3551.* ←➤

Section 4210

Dividends

.01 Write-off of Liquidating Dividends

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

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

.02 Disclosure of Dividends Per Share

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

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

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

.03 Undistributed Patronage Dividends of Agricultural Cooperative

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

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

➡→ *The next page is 3601.* ←➡

Section 4220

Quasi-reorganizations

.01 Write-up of Assets in Quasi-reorganization

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

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

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

Another paragraph in this section includes the following:

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

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

Paragraph 17 of Accounting Principles Board Opinion No. 6 states, "The Board is of the opinion that property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity. This statement is not intended to change accounting practices followed in connection with quasi-reorganizations or reorganizations."

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

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

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

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

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

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

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

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

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

Is this procedure acceptable?

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

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

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

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

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

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

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

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

➡ *The next page is 3631.* ←

Section 4230

Capital Transactions

.01 Disclosure of Transfer from Retained Earnings to Capital Stock

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

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

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

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

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

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

Reply—The difference should be charged or credited to additional paid-in capital. If there is no additional paid-in capital, any "debit" balance should first be charged to retained earnings and any remaining "debit" balance should be described in the

financial statements as a discount on preferred stock. However, in many states the law requires that issued stock must be fully paid and nonassessable and therefore, if the par value of the preferred shares exceeds the market value of the common shares this exchange may have legal implications that should be considered. [Amended]

TIS Section 5000

REVENUE AND EXPENSE

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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.

.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 arrangement, there is some doubt as to when the income should be recognized.

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

1. **Negotiable Note**

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

2. **Nonnegotiable Note**

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

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

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

4. **Commitment Letter, Contingent on Future Draws**

The company receives commitment letters from the borrower as described in No. 3 above. However, the commitment letters state that a certain amount of the

fee will not be paid unless or until certain construction draws are received from the lender.

When should revenue be recognized as earned by the client?

Reply—Revenue recognition is discussed in 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 APB 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 sched-

uled 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 APB Statement No. 4, paragraph 150, 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.

.27 Fees for Obtaining Contracts for Others

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

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

Revenue is generally recognized when both of the following conditions are met:

- (1) the earning process is complete or virtually complete, and
- (2) an exchange has taken place.

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

.28 Revenue from Private Label Sales

Inquiry—Corporation A produces certain products that are sold under Corporation B’s label. Corporation B reimburses

Corporation A for all direct costs of raw material, ingredients, and packaging plus 10¢ per pound processing fee. Corporation A prepares an invoice for each shipment which itemizes the various direct costs plus 10¢ per pound processing fee. Should Corporation A record the total invoice amount as a sale or should it record the processing fee as revenue and the reimbursed direct costs as a reduction of expenses?

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

.29 Gain from Transfer of Assets in Debt Restructuring

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

Reply—The difference of \$5,000 between the fair value of the assets transferred and the amount payable would, if material, be classified as an extraordinary gain in accordance with FASB Statement No. 15, paragraphs 13 and 21. The other difference of \$5,000 between the carrying amount of the assets and its fair value would be a gain on transfer as stated in FASB Statement No. 15, paragraph 14. The gain would be reported in accordance with APB Opinion No. 30 which states that an event or transaction is not extraordinary unless it meets both of the criteria defined in the Opinion.

➤→ *The next page is 4121.* ←➤

Section 5210

Depreciation and Depletion

.01 Change in Depreciation Method for Newly Acquired Assets

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

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

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

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

.02 Disclosure of Depreciation Expense

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

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

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

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

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

.03 Depreciation Method for Appliances in Apartment Building

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

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

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

.04 Depreciation of Clothing Rented to Individuals

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

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

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

.05 Classification of Costs of Constructing a Golf Course

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

Reply—For the costs incurred in constructing a golf course, those expenditures made to change the land itself, exclusive of buildings, should be treated as permanent improvements to the land and are not, therefore, depreciable. These costs would include clearing the land, building fairways, changing the contour of the earth by moving and filling, building sand traps, and creating water hazards. If trees are planted, and their lives can be estimated, it would appear to be proper to depreciate these over

such lives. In the absence of any reasonable estimate, trees and shrubs should be carried at cost. Any structures such as buildings, shacks or stands should be depreciated along with the costs of any vehicles such as trucks or carts, and any equipment used. A watering system should be depreciated as it is made of material that will not last indefinitely.

.06 Discontinuation of Depreciation on Demolished Hospital Building

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

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

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

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

Inquiry—The Economic Recovery Tax Act of 1981 established the Accelerated Cost Recovery System (ACRS), which replaces the depreciation system for income tax purposes. ACRS eliminates for income tax purposes the need to select a depreciation method and to determine each asset's useful life and salvage value. Instead of depreciation deductions permitted by prior tax laws, enterprises must now use recovery deductions in determining taxable income. The recovery deductions are determined by applying percentages specified by the law to the tax basis of the asset for a specified number of years.

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

Reply—Generally accepted accounting principles require that the cost of depreciable assets be allocated to expense over the expected useful life of the asset in a systematic and rational manner. In contrast, the recovery deductions required under ACRS were designed to encourage investment in productive

assets by allowing accelerated deduction of the tax basis of an asset.

If the number of years specified by ACRS for recovery deductions for an asset does not fall within a reasonable range of the asset's useful life, the recovery deductions should not be used as depreciation expense for financial reporting. Depreciation expense in financial statements for such an asset should be determined based on the asset's useful life.

If the recovery deductions for income tax purposes differ from depreciation expense for financial reporting, deferred income taxes should be provided in financial statements for the timing differences that result, as required by APB Opinion Nos. 1 and 11. (See *The CPA Letter* of November 23, 1981).

➤→ *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.

➤→ *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.

.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.

➡ *The next page is 4381.* ←

Section 5240

Cost Allocation

.01 Transfer Pricing Between Manufacturing Division and Selling Division

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

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

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

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

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

Where intracompany transactions account for a large share of the division's sales, transfer prices must be chosen carefully so that each division is encouraged to operate for the good of the company as a whole. Where intracompany sales occur only occasionally and are not an important part of the division's activities, the choice of transfer prices is not as critical, and it

may be easiest to negotiate a price or simply allow one of the divisions a "sales commission." In any event, the financial statements of the branches should be footnoted to disclose the treatment of the transaction.

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

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

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

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

.04 Research and Development Costs for Internally Developed Patents

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

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

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

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

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

.06 Expansion of an Established Enterprise

Inquiry—Does FASB Statement No. 7 apply to an established operating enterprise that is expanding?

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

.07 Computer Software Development Costs

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

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

Costs of software for a general management information system are excluded from research and development costs as indicated in FASB Interpretation No. 6, paragraph 4.

➤→ *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 paragraph 57 of APB Opinion No. 11, as amended by paragraph 4 of FASB Statement No. 37, deferred taxes which relate to current assets and current liabilities should be classified as a current liability.

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

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

.02 Balance Sheet Classification of Deferred Taxes—II

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

➤→ *The next page is 4411-3.* ←➤

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

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

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

.03 Income Statement Presentation of Operating Loss Carryback

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

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

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

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

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

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

.05 Realization of Tax Benefit of Loss Carryforward

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

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

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

.06 Tax Effect of Permanent Tax Differences in Business Combination

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

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

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

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

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

.07 Tax Effect of Undistributed Earnings of Newly Acquired Subsidiary

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

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

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

.08 Intercompany Tax Allocation for Consolidated Companies

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

credit purposes, and consolidated financial statements will be prepared.

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

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

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

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

.09 Tax Allocation Among Subsidiaries of Public Utility Holding Company

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

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

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

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

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

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

.10 Shipbuilders' Capital Construction Reserve Funds

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

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

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

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

Therefore, even if the shipping company elects to defer to future years the tax effect equivalent to that portion of the profits which 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. [Amended]

.11 Accounting for New Jobs Credit

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

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

➡ *The next page is 4501.* ←

Section 5260

Estimated Losses

.01 Recognition of Estimated Losses on Uncompleted Contracts

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

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

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

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

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

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

»»»→ *The next page is 4601.* ←«««

Section 5300

Prior Period Adjustments

.01 Correction of Error

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

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

➤➤➤→ *The next page is 4801.* ←➤➤➤

Section 5400

Extraordinary Items

.01 Loss on Abandonment of Sales Project

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

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

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

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

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

.02 Sale of Cotton Futures Commitment Contracts

Inquiry—A textile manufacturer entered into firm purchase

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

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

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

.03 Gain on Involuntary Conversion

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

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

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

»»»→ *The next page is 4851.* ←«««

Section 5500

Earnings Per Share

.01 Earnings Per Share on Combined Financial Statements

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

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

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

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

.02 Earnings Per Share of Wholly-Owned Subsidiaries

Inquiry—The annual report of a holding company with five wholly owned subsidiaries shows the consolidated net income and earnings per share of the companies. If the report also includes the individual income statements of the five subsidiaries, is it necessary to include individual earnings per share figures?

Reply—Paragraph 6 of Accounting Principles Board Opinion No. 15 concerning earnings per share states in part:

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

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

.03 Weighted Average Shares Outstanding for an Interim Period

Inquiry—A company retired some of its common stock during the first quarter of its fiscal year. Should earnings per share for the interim period be based on annualized weighted average shares outstanding or the weighted average shares outstanding during the period?

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

.04 Earnings Per Share for Two Classes of Common Stock

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

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

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

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

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

.05 Earnings Per Share with Contingently Convertible Class B Stock

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

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

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

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

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

.06 Earnings Per Share with Cumulative Preferred Stock

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

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

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

How should earnings per share be calculated under these circumstances?

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

	<u>1974</u>	<u>1973</u>
Primary Earnings Per Share:		
Number of common shares	24,000 sh.	24,000 sh.
Net income	<u>\$39,000</u>	<u>\$17,000</u>
Preferred dividends earned	<u>15,000</u>	<u>15,000</u>
Income applicable to common shares	<u>\$24,000</u>	<u>\$ 2,000</u>
Income per common share	<u><u>\$1.00</u></u>	<u><u>\$.08</u></u>
Fully Diluted Earnings Per Share:		
Number of fully diluted shares:		
Common shares	24,000 sh.	24,000 sh.
Conversion of preferred excluding dividend factor . . .	17,500	17,500
Additional shares for unpaid dividends	<u>3,000</u>	<u>1,500</u>
Total	<u><u>44,500 sh.</u></u>	<u><u>43,000 sh.</u></u>
Income (before preferred dividends)	<u>\$39,000</u>	<u>\$17,000</u>
Income per common share— assuming full dilution	<u><u>\$.88</u></u>	<u><u>\$.40*</u></u>
*As this is greater than the primary per-share figure, it is anti-dilutive and therefore should be disregarded.		
Therefore, the amounts to be reported are:		
Income per common share	<u>\$1.00</u>	<u>\$.08</u>
Income per common share— assuming full dilution	<u><u>\$.88</u></u>	<u><u>\$.08</u></u>

.07 Earnings Per Share with Noncumulative Preferred Stock

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

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

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

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

Therefore, if no dividends have been declared on the 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.....	<u>\$900</u>
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* Computation of interest reduction:

	Interest
Short-term debt (total).....\$40,000 @ 8%	<u>\$3,200</u>
Long-term debt (portion)..... 32,000 @ 5%	<u>1,600</u>
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 indeterminate, but the assumption that proceeds from exercise of option be used to retire debt would produce similar results, use of the calculations outlined in the inquiry would appear as a means of obtaining an objectively determinable figure. In presenting the statements, there should be a footnote disclosing that in cal-

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

➤ *The next page is 4891.* ←

Section 5600

Leases

.01 Fee Received by Lessor for Assignment of Lease

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

Reply—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.

.02 Lease Between Related Parties

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

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

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

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 report on the cash count, pursuant to SAS No. 29, that he made on August 22. Should this date be used in reporting on the bank's financial condition?

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

.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 re-

serves 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 insitutions) 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.

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Section 6110

Savings and Loan Associations

.02 Mutual Banks and Associations—Business Combination

Inquiry—Unlike a business entity, a mutual savings and loan association or a mutual savings bank does not have capital stock. How would a mutual savings and loan association or a mutual savings bank account for a business combination?

Reply—Although APB Opinion No. 16 does not refer specifically to combinations of mutual associations, it implies that its principles should be applied to such combinations. Further, the AICPA Audit and Accounting Guide, “Savings and Loan Associations,” provides that APB Opinion No. 16 applies to combinations of two or more mutual associations.

Some business combinations are accounted for by the pooling of interests method and others by the purchase method. APB Opinion No. 16 specifies criteria that must be met for a combination to qualify for the pooling of interests method. A combination that meets all the criteria that would apply to mutual organizations should be accounted for by the pooling of interest method. A combination not meeting all the applicable criteria should be accounted for by the purchase method. For example, a planned sale of a significant portion of the loan portfolio may cause the combination to be accounted for by the purchase method.

(The above response is consistent with an item in “The CPA Letter” dated January 11, 1982.)

.03 Mutual Banks and Associations—Valuation of Assets and Liabilities Acquired in a Purchase

Inquiry—Assuming a business combination for mutual savings and loan associations or mutual savings banks is accounted for by the purchase method, how should assets and liabilities be valued to conform with APB Opinion No. 16, paragraph 88?

Reply—According to APB Opinion No. 16 and FASB Interpretation No. 9, the assets and liabilities of an acquired mutual association should be stated at their fair values in business combinations of mutual savings and loan associations and similar institutions accounted for by the purchase method. Three areas of major concern are (1) stating the mortgage loan portfolio

at fair value, (2) stating the various savings deposits at fair value, and (3) identifying and measuring specifically identifiable intangible assets. Some considerations in those areas are:

- The purchase price is the fair values of the liabilities assumed plus the fair values of any other consideration given.
- The fair values of the loan portfolio, Government National Mortgage Association certificates (Ginnie Maes), and Federal Home Loan Mortgage Corporation Participation Certificates (Freddie Macs) should be determined by reference to their fair value in a bulk purchase.
- The discount resulting from the difference between the fair values and the unpaid principal balances of the loans and Ginnie Maes and Freddie Macs should be amortized using the interest method. The sum of the years digits method should not be used. If the discount is amortized over the estimated life of the loan portfolio as a whole rather than over the remaining terms of the individual loans in the portfolio, the life should be the remaining contractual term to maturity of the loans in the loan portfolio adjusted for expected prepayments. (APB Opinion No. 21, paragraph 15.)
- The fair values of regular savings and NOW account deposits should be the face amount plus accrued interest.
- The fair values of time savings deposits and borrowings should be determined using current interest rates for like deposits or borrowings resulting in discount or premium, which should be amortized using the interest method over the remaining terms of the liabilities.
- Consider the estimated future tax effects of amounts that are assigned to specific assets and liabilities. The existence of tax net operating loss carryforwards is one factor to consider in determining the amount of tax effects. (APB Opinion No. 16, paragraph 89.)
- Fair values should be assigned to specifically identifiable intangible assets whose fair values can be determined. Two such intangible assets to consider are (1) the capacity of existing mortgage loans and savings accounts of the acquired mutual association to generate future income or new

business and (2) the nature of the territory served by the acquired mutual association. Useful lives should be assigned to each separately identified intangible asset based on specific facts and circumstances. The fair values assigned become the cost of the assets, which should be amortized over those estimated useful lives.

- In the determination of the fair values the use of outside specialists may be necessary.
- Any amount that cannot be assigned to individual assets, including specifically identifiable intangible assets, less liabilities assumed, should be assigned to goodwill. FASB Statement No. 72, paragraph 5, specifies that goodwill should be amortized by the interest method over “the estimated remaining life of the long-term interest-bearing assets acquired,” or, “if the assets acquired in such a combination do not include a significant amount of long-term interest-bearing assets, . . . over a period not exceeding the estimated average remaining life of the existing customer (deposit) base acquired.”
- After a combination, the amortization periods for intangible assets, including goodwill, should be evaluated periodically to determine whether revised downward estimates of useful lives are warranted. See Statement No. 72, paragraphs 6 and 7.

(The above response is consistent with an item in “The CPA Letter” dated January 11, 1982, as modified by Statement No. 72.) [Amended]

.04 Mutual Banks and Associations—Determination of Acquiring and Acquired Company

Inquiry—How can an accountant determine which mutual savings and loan association or mutual savings bank is the acquiring and which is the acquired company?

Reply—APB Opinion No. 16 indicates that the identities of the acquiring mutual association and the acquired mutual association or associations are usually obvious and that the larger or the largest (usually measured by total assets) mutual association generally is the acquiring association. In the absence of persuasive evidence to the contrary, therefore, the acquiring

mutual association is the larger or the largest of the combining associations.

(The above response is consistent with an item in "The CPA Letter" dated January 11, 1982.)

➤ *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—The Statement of Accounting Principles and Standards for Federal Credit Unions, issued by the National Credit Union Administration, states that “the accrual basis of accounting provides the most complete and informative record of the financial activities of credit unions,” and recommends that large credit unions use the accrual basis of accounting. All credit unions are not required to use the accrual method. A credit union should use either the accrual basis or modified cash basis of accounting if practicable.

The auditor’s responsibility in reporting on modified cash basis statements is discussed in SAS 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.

➡ *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.

➤➤➤ → *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—General accounting standards for the effect of regulation are discussed in FASB Statement No. 71. If, as required by FASB Statement No. 71, paragraph 9, it is probable that future revenues of the utilities will be sufficient to recover the downtime costs, the costs should be deferred. [Amended]

.02 Recognizing Revenues by Public Utilities Using Cycle Billing

Inquiry—A public utility uses cycle billing in billing its customers. How should the unbilled revenues be reported?

Reply—Included in the Federal Power Commission chart of accounts for electric utilities is Account No. 173, “Accrued Utility Revenues.” This is an optional account which may be used to record power delivered to customers but not yet billed at the month end. The FPC requires that, if such an account is used, provision also be made for any purchased power received but not yet accounted for.

One utility estimates its unbilled revenues by taking the cycles of the following month and allocating to the prior month the portion of the aggregate billings for that cycle, based on days elapsed. For any cycles for which data was not available by the date the entry was needed, an estimate was made using the billing of the previous month for that cycle. However, other

methods may be devised to provide a reasonable estimate of revenues earned but not billed at the month end.

.03 Financial Statement Presentation of Power Service Rights by Electric Cooperative

Inquiry—A client is an electric cooperative. The cooperative borrows funds from the Rural Electrification Administration and by doing so is subject to certain accounting procedures required by the REA.

The cooperative has paid for rights to build its lines into certain areas to provide future tenants with electricity. The rights, which are usually granted by developers, may either run for an indefinite period or may run for a limited term, such as ten years. The contracts provide for general rights-of-way into the areas, but no specific deeds or easements are granted.

The auditors believe that these rights benefit future periods, and the costs to gain these rights should be capitalized. The REA, on the other hand, has taken the position that, since no specific titles are recorded, the expenditures are similar to promotion and advertising costs and should be expensed. How should the rights be presented on the financial statements?

Reply—If the costs in question were incurred as part of a bidding process to acquire the right to build lines into certain geographical areas to provide future tenants and/or owners with electric power, they may be appropriately capitalized under generally accepted accounting principles and APB Opinion No. 17 would apply. Otherwise, they should be expensed. [Amended]

➤→ *The next page is 5521.* ←➤

Section 6300

Insurance Companies

.01 Recognition of Commission Income by Insurance Agency

Inquiry—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.

➡ 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* [3rd edition, 1980], 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* [3rd edition, 1980] 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* [3rd edition, 1980], 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.

➤ *The next page is 5741.* ←

Section 6410

Nursing Homes

.02 Deferral of Reimbursement Income Due to Difference in Depreciation Methods

Inquiry—A nursing home has a contract to accept medicare patients. The cost reimbursement for the building that it receives from medicare is computed by using the double declining balance and a life of thirty-three years. The company has recently been acquired by a public company, and audited statements are now required. On these statements an election can be made to use the straight line method of depreciation for the equipment and building and a life of forty years on the building.

Should there be an account for the deferred income from medicare which would be derived by recomputing the medicare cost with straight line depreciation?

Reply—Deferred income (or expense) results from a timing difference between the periods in which depreciation affects reimbursement revenue and the periods in which it enters into the determination of the results of operations. When depreciation for reimbursement purposes exceeds depreciation for financial reporting purposes, income should be deferred to the extent that it is attributable to this excess depreciation.

.03 Accounting for Home Office Management Team Costs and Revenues

Inquiry—A company owns and operates nursing home subsidiaries. The parent company maintains a management team which provides accounting and management services for each subsidiary. Each subsidiary reimburses the parent company for the cost of these services.

In addition to the monthly recurring function of the home office management team, team members are involved in (1) searching for and obtaining financing of new nursing home subsidiary acquisitions, (2) developing plans for constructing new nursing homes, (3) developing plans for expanding presently owned nursing home subsidiaries, and (4) providing management consulting services to outside unrelated organizations. What would be the recommended accounting treatment for expenses incurred

(and revenue generated) by the management team in connection with these activities?

Reply—The costs related to the search for new acquisitions should be expensed as incurred in accordance with Interpretation 33 to Accounting Principles Board Opinion No. 16 which discusses costs of maintaining an “acquisitions” department.

Costs related to constructing the new nursing homes should be allocated to the new homes. Costs related to the expansion of presently owned nursing home subsidiaries should be allocated to these subsidiaries. Capitalization would not seem appropriate for items (2) and (3) because these are normal management activities.

Revenues of the home office management team in connection with services provided to unrelated organizations should be reported as miscellaneous revenue and the expenses deducted as incurred.

➤→ *The next page is 5841.* ←➤

Section 6500

Extractive Industries

.03 Disclosure of Contingent Liability for Royalties

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

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

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

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

The \$1,250,000 is a contingent liability—a commitment entirely conditioned on the actual mining of coal. Accordingly, royalties should be accrued as a liability only when, and to the extent that, tonnage (to which the royalty applies) is actually mined. In the purchase agreement, there is no liability on the overriding royalty if no coal is mined.

The rule of informative disclosure requires that the essential facts concerning the property acquisitions be indicated in a foot-

note to the statements, including an adequate explanation as to the nature and amount of the company's contingent liability.

Although there are instances where royalty payments are reflected as administrative or selling expense, in this case the royalties are paid for the right to mine the coal. The royalty cost may be viewed as a direct burden on production cost and should be accumulated as part of the cost of coal mined. The royalty cost then would be matched with revenues at the point of sale, as part of the cost of coal sold.

➤→ *The next page is 5941.* ←➤

Section 6600

Real Estate

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

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

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

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

Reply—The timing of revenue recognition for a service-type business is discussed in APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, paragraphs 150 and 151. 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 FASB Statement No. 66, *Accounting for Sales of Real Estate*, paragraph 37, are met, the percentage of completion method may be applied to each unit sold as a condominium.

.03 Accounting for Sale of Property With Option to Repurchase

Inquiry—A corporation sold a parcel of land to a bank. The corporation has an option to repurchase the land for a period of three years. The corporation received the full purchase price at the time of sale.

What is the proper accounting treatment for this transaction?

Reply—The conclusion in FASB Statement No. 66, *Accounting for Sales of Real Estate*, paragraph 26, is that a transaction whereby a seller has an obligation or an option to repurchase the property must be accounted for as a financing, leasing, or profit-sharing arrangement. A right of first refusal based on a bona fide offer by a third party is ordinarily not an obligation or an option to repurchase.

.04 Method of Recognizing Profit on Sale of Undeveloped Land with a Release Provision

Inquiry—One hundred acres of undeveloped land was sold for \$10,000 per acre for a total consideration of \$1,000,000. The buyer made a cash down payment of \$250,000, and the balance of \$750,000 is payable in three annual installments of \$250,000. The agreement has a release provision that title to the acreage will be released to the buyer on a basis of 115% of the sales price. Therefore, of the \$250,000 down payment, \$217,000 would be applicable to the release of 21.7 acres, and the balance of \$33,000 would be applicable to the remaining acreage. At this point, there would be a balance due on the sales agreement of \$750,000 against which \$33,000 would apply. The buyer would have this privilege every year, and the only security would be the land underlying the agreement.

What is the proper accounting treatment?

Reply—FASB Statement No. 66, *Accounting for Sales of Real Estate*, paragraph 15, states:

If the amounts applied to unreleased portions do not meet the initial and continuing-investment criteria as applied to the sales value of those unreleased portions, profit shall be recognized on each released portion when it meets the criteria in paragraph 5 as if each release were a separate sale.

Paragraph 5 states, in part:

Profit on real estate sales transactions shall not be recognized by the full accrual method until all of the following criteria are met:

- a. A sale is consummated.
- b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property.
- c. The seller's receivable is not subject to future subordination.
- d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with property.

Presumably, the tests referred to would have to be met continuously; that is, at the time of closing and at each release date.

The relationship of the \$33,000 to the \$750,000 is not sufficient "to constitute an adequate initial and continuing investment" related to the unreleased property. Therefore, "profit should be recognized as if each release were a separate sale" as stated in paragraph 15. [Amended]

.07 Accounting for Nonmonetary Exchange of Land

Inquiry—A real estate company is engaged in developing residential communities, but they occasionally sell undeveloped parcels of land. The company has entered into an agreement whereby it will exchange land zoned for industrial use having a cost basis of \$10,000 for residential land having a fair value of \$50,000.

Is it proper to record the land received at \$50,000 and recognize a gain of \$40,000?

Reply—APB Opinion No. 29, paragraph 21(a), indicates that "an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers . . ." does not culminate an earnings process. This exchange represents only a shift in real estate held as inventory. Therefore, the exchange should be reported on the basis of the recorded amount of the nonmonetary asset given up, \$10,000.

.08 Work Performed By Purchaser

Inquiry—As part of an agreement relating to the sale of a single family house, the purchaser agreed to make certain repairs to the property. Can the work performed by a purchaser be considered as a partial down payment?

Reply—No. FASB Statement No. 66, *Accounting for Sales of Real Estate*, paragraph 10(a), states that payments by the buyer

to third parties for improvements to the property should not constitute a down payment. Similarly, costs for repairs that the buyer incurred do not constitute a down payment.

➤ *The next page is 6041.* ←

Section 6610

Retail Land Sales Companies

.01 Financial Statement Presentation of Real Estate Developer

Inquiry—A real estate developer would like to present a balance sheet with no classifications as to current or noncurrent assets and liabilities. The statement of changes in financial position would also have to have a somewhat amended format. Is such a presentation permissible?

Reply—Yes. APB Opinion No. 19, *Reporting Changes in Financial Position*, paragraph 9, states in part:

The Board recognizes the need for flexibility, in form, content, and terminology of the Statement to meet its objectives in differing circumstances. For example, a working capital format is not relevant to an entity that does not distinguish between current and noncurrent assets and liabilities.

Under the circumstances the statement could reflect sources and uses of cash (see APB Opinion No. 19, paragraph 11).

The first sentence of the Auditing Interpretation entitled *Long Term Investments*, paragraph 13, section 9332.13 of *AICPA Professional Standards*, Volume 1, confirms the appropriateness of the use of unclassified balance sheets in some industries, such as insurance, investment, finance, and real estate. [Amended]

.02 Accounting for the Cost to Reacquire Land Sales Contracts by the Seller

Inquiry—In recent times of escalating land values, there have been instances when a land contract has been reacquired by the seller for a price in excess of the original contract in order to accumulate enough contiguous tracts to make an outright sale at the current market level.

How should the cost of reacquiring land sales contracts be treated?

Reply—Accounting for the cost to reacquire land contracts is not discussed in FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. There are differing views of how to account for these costs. One view

is that the land should be restored to inventory at its original cost, and any additional costs of reacquiring the contract should be treated as a current period expense. This viewpoint is based on the theory that such costs represent an expense incurred to cancel the contract. Another viewpoint is to treat the cost of reacquiring the contract as a capitalizable cost. This point of view is based on the theory that the contract for deed represents a claim on the land, and the costs are incurred to perfect the seller's interest in the property.

Perhaps the reasonable approach would be to treat costs to reacquire the contract for deed as expenses unless it can be clearly demonstrated that they are costs incurred to sell real estate projects that can be capitalized as prepaid costs if they are directly associated with and their recovery is reasonably expected from sales that are being accounted for under a method of accounting other than full accrual. (See FASB Statement No. 67, paragraph 18.) [Amended]

.03 Disclosure of Appraisal Value of Land Held for Resale or Development

Inquiry—A real estate development company would like to reflect appraised values of land held for resale or development in its financial statements. This would not only increase asset valuation but enhance loan capability. Is there any authority for use of appraisal values?

Reply—Cost is the proper basis for presenting land in the financial statements of the developer. As indicated in APB Opinion No. 6, “. . . property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity.” In addition, ARB No. 43, Chapter 4, indicates that:

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.

Therefore, cost is the proper basis for balance sheet presentation in the financial statements. However, footnote or other supplementary disclosure of the land's appraised value, and the basis of the appraisal, may be useful information to the reader of the financial statements. [Amended]

.04 Allocation of Land Costs to Parcels Sold

Inquiry—A land development company presently charges 10% of the selling price of a homesite as the cost of sales. Historically the cost of sales ratio to sales has ranged from 10% to 29%. Is a 15% experience rate for cost of sales appropriate?

Reply—The land costs should be allocated to lots sold based on the most recent actual experience of the company and in accordance with FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, paragraph 11. Paragraph 11 states:

The capitalized costs of real estate projects shall be assigned to individual components of the project based on specific identification. If specific identification is not practicable, capitalized costs shall be allocated as follows:

- a. Land cost and all other common costs (prior to construction) shall be allocated to each land parcel benefited. Allocation shall be based on the relative fair value before construction.
- b. Construction costs shall be allocated to individual units in the phase on the basis of relative sales value of each unit.

If allocation based on relative value also is impracticable, capitalized costs shall be allocated based on area methods (for example, square footage) or other value methods as appropriate under the circumstances. [Amended]

»»»→The next page is 6151.←«««

Section 6700

Construction Contractors

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

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

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

Reply—AICPA SOP 81-1 entitled *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, paragraph 31, and the AICPA Audit and Accounting Guide, *Construction Contractors*, page 123, state that the completed contract method may be used as the basic accounting method only if the financial position and results of operations reported on that basis would not vary from those resulting from the use of the percentage-of-completion method, “for example, in circumstances in which an entity has primarily short-term contracts.” SOP 81-1 also states in paragraph 31 that an entity using the completed contract method as its basic accounting method should depart from that policy for a single contract or a group of contracts not having the features described in the paragraph. Thus, it appears that the distinction made by the company conforms to generally accepted accounting principles. [Amended]

.05 Classification of Profit on Uncompleted Negotiated Contracts

Inquiry—A building contractor derives most of his income from negotiated contracts rather than firm bid contracts. On negotiated contracts, the contractor renders a statement to each client which includes itemized costs for a period plus an 8% fee. Later, the client remits a check for the amount of the progress billing less a 10% or 15% retainage. Previously, 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.

.10 Payments for Landfill Rights

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

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

➡ *The next page is 6351.* ←

Section 6910

Investment Companies

.01 Valuation of Securities at Cost or Fair Value

Inquiry—A two-shareholder venture capital corporation is capitalized for under \$100,000 and leveraged from stockholder loans in excess of a 50:1 debt-equity ratio. The company's business consists of providing funds in the form of loans, equity, or a combination of loans and equity to companies with no public market for their securities. Also, the company sometimes provides management supervision to its investees.

The company's equity investments are typically in companies which have a limited operating history. Valuation of such equities, notwithstanding the care, good faith, and expertise of those involved in the valuation process, is difficult at best. Because of the uncertainty concerning the value of the investments, it seems likely that if all equities were carried at value there would be very large changes from year to year in unrealized appreciation.

Can the company present its securities at cost on the balance sheet with the company's estimate of the value of the equities disclosed in a footnote to financial statements?

Reply—The company's securities should not be valued at cost, but at estimated fair value as discussed in the AICPA Industry Audit Guide, *Audits of Investment Companies* (1973), pages 16 and 17, 35 through 37, and 46 through 48. If the company insists on valuing the securities at cost, an opinion similar to that shown on pages 111 and 112 would be required to be expressed by the auditor.

.03 Basis for Valuation of Investments in Rental Property

Inquiry—A client, an investment company, has substantial investments in assets other than securities, particularly rental real estate. The AICPA Industry Audit Guide, *Audits of Investment Companies* (1973), seems to discuss only the valuation of investments in securities. In the regulations to the Investment Company Act of 1940, however, Rule 2a-4, paragraph (a)(1) states, "Portfolio securities with respect to which market quotations are readily available shall be valued at current market

value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company." How should the investment in rental property be reported?

Reply—The AICPA Industry Audit Guide, *Audits of Investment Companies*, states that, in general, all investment companies should report their security investments at value. This principle would also apply to the rental property in this client's portfolio.

Pages 109-110 of the guide contain an example of a form which may be used for expressing an opinion on financial statements in which there is a material portion of securities valued "in good faith" by the board of directors and for which the auditor has examined documentation supporting such securities valuation and found nothing to indicate that the valuation principles are not acceptable or have not been consistently applied or that the valuation is not reasonably supported by competent evidential matter (also see page 48 of the guide).

The SEC's Codification of Financial Reporting Policies, Sec. 404.03.b.iv (ASR 118) includes a discussion of securities valued "in good faith."

➡ *The next page is 6411.* ←

Section 6920

Voluntary Health and Welfare Organizations

.03 Basis of Valuation of Donated Materials

Inquiry—A nonprofit, church-related home for custodial care and placement of homeless children receives cash and noncash gifts daily. The gifts include such items as bread, a used pickup truck, and livestock, and other agricultural commodities grown, raised, or produced by the donor. At what value should such gifts in kind be recorded?

Reply—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.

.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.

➤ *The next page is 6471.* ←

Section 6930

Employee Health and Welfare Benefit Funds

.01 Computation of Liability for Accumulated Eligibility Credits

Inquiry—An insured fund receives premiums of \$50 per month per individual. Accumulated eligibility credits are as follows: 400 members, 3 months; 500 members, 6 months; 800 members, 9 months; and 0 members, 12 months. Would the following computation of liability for accumulated eligibility credits be acceptable?

400 members x 3 months x \$50	\$ 60,000
500 members x 6 months x \$50	150,000
800 members x 9 months x \$50	360,000
	<hr/>
Liability for accumulated eligibility credits	<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 Audit and Accounting Guide, *Audits of Employee Benefit Plans* (1983), indicates in paragraphs 4.19 and 4.22 that claims incurred, but not reported, and future payment of benefits based on participant's accumulated eligibility arising from hours accumulated should be presented as liabilities on the balance sheet of the fund. How should the maintenance of benefits provision be shown?

Reply—Potential benefit claims should be reflected as “estimated health claims incurred but not reported” and “estimated future benefits based on participant's accumulated eligibility” (see page 163 of the Audit and Accounting Guide). The cash account should be segregated to disclose the portion related to this obligation. There should also be adequate disclosure of the maintenance of benefits provision of the agreement. [Amended]

.03 Financial Statement Presentation of Underwriting Deficits

Inquiry—The administrator of an employee health and welfare benefit plan has questioned an item on the plan's balance sheet. The item appears in the liabilities section as follows:

Reserve for underwriting deficit—(Note 3) \$10,000

Note 3 reads as follows:

Reserve for underwriting deficit represents a liability with the XYZ Life Insurance Company for claims paid in excess of premiums during the current policy year. This liability will be applied to reduce any refunds which may accrue in the future. Such a refund was received during the current year.

The related debit to the credit setting up the liability was to “Underwriting Deficit,” and is included in health claims deductions in the “Statement of Changes in Net Assets Available for Benefits.”

The administrator takes the position that this item should be excluded entirely from the financial statements because:

1. The policy provides that any underwriting deficit in one policy year is not immediately recoverable by the insurance company but only recoverable against underwriting “gains” of succeeding years, if any.
2. Upon cancellation of the policy by the underwriter, the fund is relieved of any liability for any unrecovered underwriting deficit existing on date of cancellation.

3. Although there were usually underwriting “gains” in past years, there is no assurance that future underwriting “gains” will occur to permit recovery of the deficit.

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

Reply—The AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans* (1983), paragraphs 4.17 and 4.18, discusses accrued experience rating adjustments. The Audit and Accounting Guide, paragraph 4.18, states:

Experience ratings, determined by the insurance company or by estimates, may also result in a premium deficit. Premium deficits should be recorded as a liability of the plan (or a reduction of a deposit, if applicable) if (a) it is probable that the deficit will be applied against the amounts of future premiums or experience rating refunds and (b) the amount can be reasonably estimated. If no accrual is made for premium deficit because one or both of the conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the premium deficit should be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.

A footnote states that considerations in determining whether it is probable that a premium deficit will be applied against future premiums or refunds include (a) the extent to which the contract with the insurance company requires payment of such deficits and (b) whether the plan intends to transfer coverage to another insurance company.

The way in which the so-called “underwriting deficits” offset against underwriting “gains” indicates that the “underwriting deficits” are comparable to the situation discussed in the audit and accounting guide. Therefore, if it is probable that there will be future “underwriting gains” under the contract, the “underwriting deficits” should be reported as a liability with accompanying footnote disclosure. [Amended]

➤➤➤ → *The next page is 6521.* ← ➤➤➤

Section 6935

Profit Sharing 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.

APB Opinion No. 22, paragraph 8, which deals with the applicability of the disclosure of accounting policies, states that a description of all significant accounting policies of the reporting entities should be included as an integral part of the financial statements whenever the statements issued purport to fairly present financial position, changes in financial position, and the results of operations in accordance with generally accepted

accounting principles. APB Opinion No. 22 applies to both businesses and nonprofit organizations, and, since no specific exemptions are listed, it would appear necessary to disclose the accounting policies followed in the financial statements of the profit sharing plan.

➤→ *The next page is 6551.* ←➤

Section 6940

Franchisors

.01 Method of Accounting for Sale of Territorial Franchise Right

Inquiry—A client sells territorial franchise rights to region managers for \$30,000 with ten percent taken in cash and the remainder as a note. The region manager in turn sells franchises in his territory. The note is payable at the rate of \$1000 per franchise sold in the territory but is due in three years regardless of the number of franchises sold.

The collectibility of the notes depends on the performance of the region managers. The company has been able to resell territories of managers who have been unsuccessful, and the down payments have been refunded in these instances.

What is the proper method of accounting for these franchise fees and the related costs of selling the territories?

Reply—In discussing initial franchise fees for area franchises, FASB Statement No. 45, paragraph 8, states: “. . . revenue ordinarily shall be recognized when all material services or conditions relating to the sale(s) have been substantially performed or satisfied by the franchisor.” In paragraph 5, the Board defines substantial performance as follows:

. . . Substantial performance for the franchisor means that (a) the franchisor has no remaining obligation or intent—by agreement, trade practice, or law—to refund any cash received or forgive any unpaid notes or receivables; (b) substantially all of the initial services of the franchisor required by the franchise agreement have been performed; and (c) no other material conditions or obligations related to the determination of substantial performance exists . . .

Therefore, the sale of the regions is not a completed transaction which would allow the recognition of income when the sale is made (i. e., when the down payment and notes are received) since the company’s practice of refunding down payments to region managers and, in effect, excusing nonpayment of their notes would violate item (a) above.

Since payment of the notes is on the basis of specific performance (i. e., at the rate of \$1,000 per franchise sold in the region),

as a practical matter, a reasonable basis for recognizing deferred revenue would be over the estimated number of franchises to be opened in a region.

With regard to the costs of selling the territories, FASB Statement No. 45, paragraph 17, states:

Direct (incremental) costs relating to franchise sales for which revenue has not been recognized ordinarily shall be deferred until the related revenue is recognized; however, the deferred costs shall not exceed anticipated revenue less estimated additional related costs. Indirect costs of a regular and recurring nature that are incurred irrespective of the level of sales, such as general, selling, and administrative costs, shall be expensed as incurred. Costs yet to be incurred shall be accrued and charged against income no later than the period in which the related revenue is recognized . . .

Therefore, deferral and amortization of costs “incurred to produce the region sales” could be accounted for in a manner similar to the deferral and recognition of revenue discussed in the preceding paragraph. The operating expenses of the company should be charged off as a period cost. [Amended]

➤➤➤→ *The next page is 6601.* ←➤➤➤

Section 6950

State and Local Governmental Units

.01 Financial Statements of Indian Tribe as a Governmental Entity

Inquiry—A CPA has been engaged by an Indian tribe to render an opinion on their financial statements which have previously been prepared on the assumption that the tribe was a commercial enterprise. The tribe receives numerous federal grants and administers several National Economic Development Association and Housing and Urban Development programs. Should the tribe be viewed as a governmental entity with individual fund statements presented for the various entities within the tribe, or should a single consolidated balance sheet be prepared for the tribe as a whole?

Reply—The tribe should probably be considered as a sovereign entity, presumably with a tax-exempt status, and the financial statements of the tribe should be prepared and reported as those of a local governmental unit. The commercial dealings of the tribe should be reported as enterprise funds. There should also be adequate footnote disclosure of the amounts received from the several federal agencies, and the prohibitions and limitations related to the grants and projects should be described.

.02 Balance Sheet Presentation of Outside Interest in Water Facilities

Inquiry—A government authority is currently constructing a dam and reservoir for a city. Under a previous contract executed several years earlier between these two entities, the city agreed to purchase water from the authority provided that the revenues produced were used in the eventual construction of a dam and reservoir similar to that now under construction. Amounts paid to the authority under the contract were treated as any other water sales and made their way into Accumulated Operating Revenues in the authority's accounts. Recently an adjustment was made on the authority's books reducing the Accumulated Operating Revenues by the amount of previously earned water

revenue leaving only the authority's net investment in the project remaining in its accounts. What is the proper presentation in the balance sheet of the authority of the equity held by the municipality in facilities serving both the authority and the municipality?

Reply—If the authority has legal title to the facilities, it would appear that the municipality's equity should be treated as a credit item, similar to the treatment on the books of industrial companies of minority interest, and similar to the treatment on statements of public utilities of contributions in aid construction.

Even if legal title to the facilities does not vest in the authority, it would appear that, since the authority has operating authority over the facilities, such treatment would still be acceptable. Alternatively, the equity of the municipality might be shown on the asset side of the authority's balance sheet as a deduction from the fixed assets.

.03 Effect on Auditor's Opinion of Inconsistency in Charging Operating Costs to Funds of School Districts

Inquiry—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.

.12 Depreciation and Contributions in Aid to Construction

Inquiry—How should a municipal utility report depreciation on assets acquired from contributions in aid to construction?

Reply—A discussion of reporting depreciation of a transportation system on assets acquired from contributions in aid to

construction is found on pages 84-85 of the AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*. Page 84 includes the following statement:

While depreciation on all assets should be shown in the income statement, the amount applicable to assets acquired from contributions in aid to construction should be transferred to the related contribution account instead of to retained earnings. . . .

Although the discussion in the Guide was intended to apply to transportation systems, the reporting applies to depreciation on other types of assets acquired from contributions in aid to construction.

.13 Status of NCGA Statements

Inquiry—Are financial statements of an airport authority which follow the requirements of Statement 2 issued by the National Council on Governmental Accounting (NCGA) considered to be in conformity with generally accepted accounting principles?

Reply—Yes. AICPA SOP No. 80-2, footnote 1, indicates that financial statements presented in accordance with NCGA Statement 2 are consistent with the AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*. AICPA SOP 80-2, paragraph 3, indicates that the guide is in conformity with NCGA Statement 1, which is considered generally accepted accounting principles for State and Local Governmental Units.

➤→ **The next page is 6701.** ←➤

Section 6960

Colleges and Universities

.01 Auditors' Reporting Obligations in Connection with Departures from Industry Audit Guides

Inquiry—A client is a state supported college. The state supported colleges in this state have had a uniform published accounting manual for several years which sets forth their accounts and financial statement presentation. The recent AICPA Industry Audit Guide, *Audits of Colleges and Universities* (1973), has brought forth certain financial statement changes for these state supported institutions. Many of the changes will be incorporated into their manual, however, a few areas of change which could be significant are not scheduled to be accepted for the manual at the present time.

What are the auditor's reporting obligations when a client's financial statements do not comply with the provisions of an Industry Audit Guide?

Reply—The Industry Audit Guides and Industry Accounting Guides of the AICPA contain a statement such as the following in their "Notice to Readers":

Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

As a practical matter, the auditor should indicate the departures from the Guide in a middle paragraph if he believes the departures require a qualified or adverse opinion.

.02 Valuation of Fixed Assets When Historical Records are Unavailable

Inquiry—A university does not have records of the historical costs of its fixed assets.

What method can the university use to arrive at a proper value for these assets for financial statement purposes?

Reply—Page 48 of the AICPA Industry Audit Guide, *Audits of Colleges and Universities*, states, "In the absence of historical cost records, the assets may be stated at historically based appraised values with subsequent additions at cost."

This means that the appraisals should be based on values existing at the actual or approximate dates of acquisition for

these assets and should take into account depreciation since acquisition.

.03 Mandatory Transfer of Interest on College's Construction Loans

Inquiry—The AICPA Industry Audit Guide, *Audits of Colleges and Universities* (1973), states on page 29:

Provision for Debt Service on Educational Plant. Includes mandatory debt service provisions relating to educational plant including amounts set aside for debt retirement, interest and required provisions for renewals and replacements. . . .

Does this include interest currently paid on loans from a bank to temporarily finance reconstruction of the plant?

Reply—If the loans are in the nature of construction loans being used until permanent financing for the plant is arranged, the interest paid can be treated as a mandatory transfer as discussed on page 29 and illustrated on page 67 of the guide.

.04 Direct and Indirect Costs to be Included in Educational and General Expenses and Auxiliary Enterprises

Inquiry—Is it in accordance with the AICPA Industry Audit Guide *Audits of Colleges and Universities* (1973) for various expenditures classified as “educational and general” and as “auxiliary enterprises” (as illustrated on pages 66 and 67 of the Guide) to include only direct costs, or must indirect costs be allocated to these items?

Reply—The AICPA Industry Audit Guide *Audits of Colleges and Universities* states on page 26:

Current funds expenditures and mandatory transfers comprise (1) all expenses incurred, determined in accordance with the generally accepted accrual method of accounting, except for the omission of depreciation; (2) expenditures from current funds for renewals and replacements of equipment; and (3) amounts transferred to plant funds as required for debt service, including principal, interest, and mandatory provisions for renewals and replacement of facilities.

Pages 29 and 30 contain a discussion of auxiliary enterprise expenditures and mandatory transfers and indicate:

This category of expenditures embraces all costs of operating the auxiliary enterprises, including charges for operation and maintenance of physical plant, general administration, and general institutional expenses; also included are other direct and indirect costs whether charged directly as expenditures or allocated as a proportionate share of costs of other departments or units.

Therefore, in accordance with the guide, the various expenditures classified as "educational and general" and as "auxiliary enterprises" should include both direct and indirect costs applicable to those items.

.05 Accounting for Pledges Receivable as Assets

Inquiry—A fund-raising foundation is associated with a state supported university. The foundation's financial statements are prepared on a modified cash basis accounting system.

The foundation's statements include pledges receivable as an asset. This is offset on the liabilities side of the balance sheet by deferred revenue. The pledges are substantiated in writing, and most of these are being paid over a ten-year period in even installments, but this is not required. Payments may be made on the pledge as the donor pleases. The foundation feels that the pledges should not be taken into revenue and fund balance until the pledges are collected. An allowance for uncollectible pledges has not been established. Do the procedures outlined adhere to generally accepted accounting principles?

Reply—The AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (1974), indicates that pledges receivable should be recorded as assets when received, with appropriate provision for uncollectibles. If the pledge will not be collected within the ensuing year, there should be appropriate discount provided in accordance with Accounting Principles Board Opinion No. 21. The Industry Audit Guide, *Audits of Colleges and Universities* (1973), states on page 8:

Pledges of gifts, including uncollected subscriptions, subscription notes, and estate notes, should be disclosed in the notes unless they are reported in the financial statements. The notes to the financial statements should disclose the gross amounts by time periods over which the pledges are to be collected and related restrictions, if any, as to use.

If the pledges are reported in the financial statements, they should be accounted for at their estimated net realizable value in the same manner as gifts received (except as to asset classification, for which pledges would be reported as a receivable), and credited to unrestricted revenues, deferred income, current restricted funds, plant funds, etc., as appropriate. The estimated net realizable value comprehends the present value of long-term pledges and reductions for any allowance for uncollectible pledges.

.06 Expenditures for Library Books

Inquiry—Chapter 6, “Current Funds Expenditures and Transfers,” of the AICPA Industry Audit Guide, *Audits of Colleges and Universities*, refers on page 28 to accounting for library books, as follows:

Libraries. Includes separately organized libraries, both general and departmental. Expenditures include the cost of books, catalogues, subscriptions, binding, and audio-visual aids as well as expenditures for personal services, supplies, and equipment.

What is the accounting for library books in financial statements on the accrual basis?

Reply—The term “expenditures” used in the Guide connotes “outlays” rather than “expenses.” Accordingly, as indicated on pages 47, 48, 63, 66, and 68 of the Guide, some expenditures for library books may be capitalized. It is standard practice to view the purchase of library books as a current fund expenditure with a debit to libraries and a credit to cash. At the same time, an entry is made in the plant fund capitalizing the library books. This treatment would apply to purchases of both new books and replacements. Page 48 of the Guide indicates that library books should be valued in the plant fund at cost or some other reasonable basis.

.07 Changes in Assumptions Related to Annuity Funds

Inquiry—The AICPA Industry Audit Guide, *Audits of Colleges and Universities*, states that the annuity liability and fund balance of annuity funds are adjusted periodically for changes in life expectancy. Are the liability and fund balance also adjusted for changes in dividend and interest rates?

Reply—All assumptions included in the computation for annuity liability should be evaluated if deviations between the assumptions and current experience are sufficiently material. Adjustments to the annuity liability and fund balance would include life expectancy and rates of dividends and interest, as well as realized and unrealized gains and losses on securities held. Basically, the liability should represent the present value at the date of the remaining annuity payments.

.09 Revenue and Expenditures for Summer Session

Inquiry—If a special academic term such as a summer session begins in one fiscal year and ends in another fiscal year, in which year or years should the revenue and expenditures for the special term be recognized?

Reply—Page 7 of the AICPA Industry Audit Guide, *Audits of Colleges and Universities*, states:

Revenues and expenditures of an academic term, such as a summer session, which is conducted over a fiscal year end, should be reported totally within the fiscal year in which the program is predominantly conducted.

In other words, if six weeks of an eleven week summer session are in fiscal year 19x1 and five weeks are in fiscal year 19x2, the summer session revenue and expenditures should be reported in fiscal year 19x1.

The exception to strict accrual basis accounting stated on page 7 of the Guide reflects the general practice of colleges and universities to account for an entire summer or special session in one or another fiscal year—the year that contains the greater portion of the program. Whether the general practice, or some other practice is adopted, the practice should be followed consistently.

.11 Accounting for Compensated Absences

Inquiry—FASB Statement No. 43, *Accounting for Compensated Absences*, requires an employer to accrue a liability for employees' rights to receive compensation for future absences if certain conditions are met. The National Association of Colleges and University Business Officers (NACUBO) asked the FASB to defer the applicability for FASB Statement No. 43 to colleges and universities, which use fund accounting until fund accounting questions have been resolved.

The Board decided not to defer the applicability of FASB Statement No. 43 to colleges and universities and indicated that the statement applies to institutions covered by the AICPA industry audit guide, *Audits of Colleges and Universities*. The audit guide states that it covers "nonprofit institutions of higher education including colleges, universities, community or junior colleges." Such an institution therefore should accrue a liability for compensated absences in accordance with FASB Statement No. 43.

Practitioners have raised the following questions:

- 1) How should the charge be accounted for when the liability is first recorded?
- 2) Can a receivable and related revenue be recorded for the portion of the liability expected to be paid from present or future state appropriations or grants and contracts for sponsored research and training programs?
- 3) Can the effect of the charge on the unrestricted current fund balance caused by recognition of such a liability be offset in whole or in part by interfund transfers resulting in a receivable in the unrestricted current fund?

Reply—Although the audit guide was published before FASB Statement No. 43 was issued and therefore does not refer specifically to the application of the statement to those institutions, the audit guide provides guidance that can be applied to the questions.

The accounting standards executive committee discussed the above questions and made these observations to clarify the application of FASB Statement No. 43 within the guidance provided by the audit guide:

- 1) The liability and charge for compensated absences related to current and previous years should be recorded in the unrestricted current fund. Neither the liability nor the charge should be recorded in the plant funds.
- 2) A receivable and related revenue should be recognized only if the receivable meets the definition of an asset in FASB Statement of Financial Accounting Concepts No. 3, *Elements of Financial Statements of Business Enterprises*. In applying the definition, the college or university should consider factors such as measurability, collectibility and legal rights and should look, for example, to entitlements under state constitutions or contracts with the federal government.
- 3) The effect of the charge on the unrestricted current fund balance caused by recognition of such a liability may be offset in whole or in part by interfund transfers resulting in a receivable in the unrestricted current fund only if (1) unrestricted assets are available for permanent transfer and (2) payment (or settlement by other means) to the

unrestricted current fund is expected within a reasonable period of time.

(The above response is consistent with an item in "The CPA Letter" dated September 13, 1982.)

TIS Section 7000

SPECIALIZED ORGANIZATIONAL PROBLEMS

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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.

➤→ *The next page is 7071.* ←➤

Section 7200

Partnerships

.01 Balance Sheet Presentation of Drawings in Excess of Capital Contributions

Inquiry—Two partners each contributed capital of \$100 to form a partnership for the construction of a shopping center. The partnership has obtained several loans to fund the construction, but no payments on these loans are due for two years. The partners each withdrew excess funds of \$50,000 from the partnership out of the proceeds of the loans.

How would the balance sheet show the \$200 of capital and \$100,000 of withdrawals?

Reply—Whether the \$50,000 payments to the partners are permissible depends on the terms of the construction loan commitment. If the partnership agreement is silent concerning these payments, and they are, in fact, not loans to the partners, the \$50,000 withdrawn by each partner represents drawings in anticipation of profits. As drawing accounts, they would normally be closed to the partners' capital accounts. In the situation presented, it would result in a "negative" capital account for each partner in the amount of \$49,900 in the partners' equity section of the balance sheet. Full disclosure of the circumstances causing the negative balance should also be included.

.02 Provision for Income Taxes on Partnership Income

Inquiry—A partnership agreement provides that in computing net profits, there will be a provision for income taxes, and the amount of the provision for income taxes will be considered an expense of the partnership. In the preparation of the income statement, would the net profit figure after income taxes be considered as having been determined according to generally accepted accounting principles?

Reply—Between themselves, partners may agree to compute net profits in any fashion they wish; but for financial presentation purposes, a provision for income taxes should not be set up. The absence of this item in the financial statement can be explained in the form of a footnote to the income statement. If the income statement shows a net profit figure after income taxes,

the statement is not prepared in accordance with generally accepted accounting principles.

.03 Provision for Deferred State Franchise Tax on Partnership Income

Inquiry—Being a partnership, a firm is not liable for federal income taxes; however, the company must pay a state franchise tax which is based on income. As with income taxes, there are several factors that will result in differences between taxable income and book income. Must there be a provision for deferred state franchise tax on the financial statements?

Reply—APB Opinion No. 11, paragraph 13(a), defines income taxes as used in the Opinion to include “foreign, state and other taxes (including franchise taxes) based on income.” Therefore, deferred tax accounting would be necessary for any material amount of franchise tax on a difference in income that is a “timing difference” as defined in APB Opinion No. 11.

.05 Financial Statements of a Limited Partnership

Inquiry—An auditor renders an opinion on the financial statements of a limited partnership. Should the financial statements of the limited partnership and the audit report thereon include, within the same report cover, the financial statements of and audit report on the general corporate partner?

Reply—Since the reporting entity on which the auditor is issuing an opinion is the limited partnership, it is not necessary to include the financial statements of and audit report on the general corporate partner. However, the limited partnership financial statements should disclose that it is a limited partnership.

.06 Balance Sheet Presentation of Future Capital Contributions From Limited Partners

Inquiry—Should future capital contributions, evidenced by nonnegotiable promissory notes, from limited partners be classified as an asset or as a reduction of partners' capital on the partnership balance sheet?

Reply—No authoritative literature deals with this problem. An analogous situation is that of stock subscriptions receivable.

APB Opinion No. 25, *Accounting for Stock Issued to Employees*, paragraph 8, note 2, indicates the fact that stock subscriptions receivable may in substance be the same as the grant of a stock option and should therefore be recorded as a reduction of stockholders' equity.

Similarly, reduction of partners' capital would be acceptable accounting for future capital contributions.

»»»→ *The next page is 7171.* ←«««

Section 7300

Not-For-Profit Organizations

.02 Balance Sheet Presentation of Rental Houses with Purchase Options

Inquiry—A nonprofit organization provides housing to members of minority groups in areas predominantly occupied by majority groups. The organization sometimes arranges outside financing for the prospective occupant and grants second mortgages to facilitate the purchase. When it is difficult or impossible to arrange adequate primary financing for a prospective occupant, the organization purchases the residence and rents it to the occupant granting him an option to purchase at the organization's cost plus any major repairs made or capitalized expenses and an amount to cover the costs of acquisition. These options run for various lengths of time and, in some cases, may be exercisable indefinitely. The association does not record depreciation on its books and considers the houses as an inventory item to which it holds title only until proper financing can be obtained by the occupants. Past experience indicates that the houses are sold for an amount equal to, or in excess of, cost and that the trend of real estate prices in the general area is upward.

Is it appropriate for the organization to omit depreciation on these houses and to carry them as inventory items in current assets? Should the balance sheet show only the net equity as an asset (the cost reduced by the first mortgage balance) or show the total cost as an asset and the mortgage debt divided between current and noncurrent liabilities?

Reply—For houses owned by the organization only until proper financing can be obtained by the occupants, it is appropriate for the organization to omit depreciation and to show them as an inventory item in current assets. However, with regard to the situation where it is difficult or impossible to arrange adequate primary financing for a prospective occupant and where the client purchases the residence and rents it to the occupant with a purchase option, this residence should be carried as a fixed asset on the balance sheet with a corresponding mortgage obligation, if any, shown on the liability side of the balance sheet. This

residence should be depreciated over its expected useful life. When and if the tenant purchases the residence, the asset would be removed from the fixed asset category and a gain or loss recorded upon disposition. The mortgage payable should, of course, be divided between current and noncurrent liabilities.

.05 Accounting for Nonprofit Company's Investments in Securities of Subsidiaries

Inquiry—A client, a state farm bureau which is a nonprofit organization, owns capital stock in two corporations. The farm bureau owns 100% of the outstanding capital stock of a corporation which sells equipment parts to farm bureau dealers. The bureau also owns 100% of the preferred stock of a grain marketing concern, while farm bureau members own 100% of the common stock.

The farm bureau has not consolidated the subsidiaries in its financial statements because it is felt the operations of the companies are incompatible for consolidation. Should the investments, however, be accounted for by the equity method?

Reply—APB Opinion No. 18, paragraph 2(b) indicates that the Opinion does not apply to investments in common stock held by nonbusiness entities. Ownership of voting preferred stock is used to test for the 20% ownership under paragraph 17, but the equity method is applied to investments in common stock. Accounting for the bureau's investment in the equipment parts corporation by the equity method may be desirable but not required. The equity method should not be used for the preferred stock investment; it should be carried at either fair value or lower of cost or fair value. [Amended]

.06 Valuation of Marketable Securities Held by Trustee for Life Beneficiaries

Inquiry—A charitable society was bequeathed various marketable securities. The terms of the trust require the net income to be paid to the life beneficiaries, and upon the death of the last survivor, the securities will become the property of the charitable society. What value should be used for the securities when they are received by the charitable organization?

Reply—When legal title to the securities devolves to the charitable society, the society should record the securities in the same manner as a nonprofit organization ordinarily records a current gift, donation or bequest. Generally accepted accounting principles support the use of fair market value at the date of the society's succession to legal title.

.07 Valuation of Contributed Services to Tax-Exempt Organizations

Inquiry—How should tax-exempt organizations treat contributed services such as those of unpaid corporate directors or other services?

Reply—The AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, pages 21-22, and AICPA SOP 78-10, paragraphs 67-70, specifically deal with services donated to tax exempt organizations. Both the Guide and Statement of Position indicate that a recipient organization should not record a value for donated services unless specific circumstances exist. Notes to the financial statements of the recipient organization should disclose the donated services that have been recorded and those that have not. The methods used to value, record, and report donated services should be disclosed. [Amended]

.08 Income Statement Presentation of Grants-In-Aid

Inquiry—Should grants-in-aid for operating expenses of a nonprofit organization be set up on the income statement net of the expenses or gross of expenses?

Reply—Unrestricted grants-in-aid should be shown gross on the income statement and properly designated.

.09 Exclusion from Revenue of Designated Gifts Accepted as Custodian

Inquiry—A nonprofit voluntary welfare organization's principal program activity is to subsidize other institutions for the support of children in their care. Revenues of the organization are derived mainly from contributions from the public in response to radio, television and magazine appeals. Approximately

80 percent of total revenues are received from sponsors who agree to sponsor a child in one of the institutions being subsidized by the organization. In consideration for the voluntary acceptance of a sponsorship obligation by a donor, one of the subsidized institutions is authorized to accept the care of a child from a waiting list carried by the institution. The cost to the donor for becoming a sponsor is the payment of a specified amount per month to the organization.

As a part of its effort in fostering a personal relationship between sponsor and child, the sponsor is encouraged to send cash through the organization from time to time for delivery to the child or for the purchase, by the institution superintendent, of a personal gift from the sponsor to the child on such occasions as Christmas, birthdays, etc. The organization transmits these personal "designated gifts" from the sponsor to the child as a custodial function, without any deduction for handling or administrative costs.

Are such designated gifts received from sponsors for delivery to a specified child includible in revenue of the organization, or are such designated gifts to be excluded from revenue and treated instead as funds accepted in a custodial capacity?

Reply—The designated gifts received from sponsors should be excluded from revenue and treated as funds accepted in a custodial capacity only. The agency having custodial funds should recognize this accountability for them by including them in its balance sheet as an entirely separate fund group.

The AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (1974), contains an explanation of custodian funds on page 3.

.12 Inventory Valuation for a Nonprofit Scientific Corporation

Inquiry—Products produced by a nonprofit scientific corporation are sold at prices which are less than production costs. The difference between cost and sale proceeds is covered by grants. The corporation's balance sheet shows inventories valued at an arbitrary amount with a notation that such amount is not to indicate true value but to indicate the existence of inventories. A portion of inventories is considered as base stock and is classified as a fixed asset. No provision is made for distribution,

handling, or storage costs. For the above described situation, what is the proper method of pricing inventories?

Reply—Statement No. 5 of Accounting Research Bulletin No. 43, Chapter 4 states:

A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as *market*.

Accordingly, inventories should be valued at lower of cost or market and not at an arbitrary amount. The entire amount of inventory, including the base stock, should be shown as inventory, not as fixed assets. Under Statement No. 6 of ARB No. 43, Chapter 4, the distribution and handling costs can be considered as “reasonably predictable costs of completion and disposal” and should be deducted from the sales price to arrive at net realizable value. The storage costs should be accounted for as period costs. [Amended]

.13 Retention of Life Estate By Donor of Property

Inquiry—A parcel of property is donated to a nonprofit educational foundation with the donor retaining a life estate in the property. When should the gift be recorded? Should the gift be recorded at current market value or at discounted estimated value of the life estate? What disclosure of the gift should be made in the financial statements of the foundation? Should the life estate be recorded as a liability?

Reply—Since the AICPA Audit Guide, *Audits of Colleges and Universities*, applies to this situation, the transfer of the parcel of property should be recorded at its fair market value as of the date of the gift in accordance with the discussion on page 8 of the guide. The term of the gift, particularly that the donor retains a life estate in the property should be disclosed. The life estate should not be reported as a liability.

.14 Valuation of Assets Purchased at Nominal Prices

Inquiry—A nonprofit organization has the right to purchase government surplus equipment at nominal prices. The organiza-

tion purchased a radio station tower antenna for \$1 paid to the Federal Government plus \$200 paid to a State Government to handle the paper work, etc. The fair market value of the asset approximates \$10,000. The organization is not allowed to sell the asset until after four years have elapsed. Can the organization record the asset at its fair market value?

Reply—Since there appears to be donative aspects to the purchased asset, the asset should be recorded at fair market value when purchased, and the donation recognized. The transaction should be adequately disclosed, including the restriction regarding sale of the asset.

.15 Accounting for CETA Grants

Inquiry—The federal government reimburses a nonprofit entity for salaries, employee benefits, and certain administrative costs paid to or on behalf of programs carried on and employees hired under CETA grants. How should the nonprofit entity report the CETA reimbursements in the statement of revenue and expenditures?

Reply—The reimbursement of expenditures and grants should be reported as a separate component of revenue. [Amended]

.16 Gifts of Life Insurance Policies

Inquiry—Should a nonprofit organization record a gift of a life insurance policy at the cash surrender value or face amount?

Reply—A nonprofit organization should record gifts of insurance at the cash surrender value, if any.

.17 Authority of AICPA SOP 78-10

Inquiry—What is the authority of SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*?

Reply—The introduction to SOP 78-10 states that SOP's do not establish standards enforceable under the Institute's code of professional ethics, but are intended to be considered, as deemed appropriate, by bodies having authority to issue pro-

nouncements on the subject. The AICPA audit and accounting guide entitled *Audits of Certain Nonprofit Organizations* contains the following discussion of SOP 78-10:

On December 31, 1978, the AICPA issued Statement of Position (SOP) 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*. At that time, the Financial Accounting Standards Board (FASB) was studying the objectives of financial reporting by nonbusiness organizations. Thus, no effective date was established for adoption of the accounting principles recommended in SOP 78-10. In September 1979 the FASB issued Statement of Financial Accounting Standards no. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*, which specified that the specialized accounting and reporting principles and practices in the SOP are preferable accounting principles for purposes of justifying a change in accounting principles as required by APB Opinion no. 20, *Accounting Changes*. In December 1980 the FASB issued Statement of Financial Accounting Concepts no. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, which establishes the objectives of general-purpose external financial reporting by nonprofit ("nonbusiness") organizations. However, the FASB is continuing to study accounting standards for nonprofit organizations, and no effective date has been established for SOP 78-10.

In addition, SAS No. 5, paragraph 7 (as amended by SAS No. 43) states that AICPA Statements of Position are sources of established accounting principles that the auditor should consider if accounting treatment is not specified in a more authoritative pronouncement.

Although SOP's do not establish enforceable accounting standards, they do present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical committee of the AICPA authorized to speak for the AICPA on financial accounting and reporting and cost accounting. Thus, an auditor's opinion on the financial statements of an entity that does not follow the recommendations in SOP 78-10 should not necessarily be qualified. However, an auditor should encourage his client to follow these recommendations since they represent the best thinking of the profession at this time. [Amended]

➡ **The next page is 7351.** ←

Section 7400

Related Parties

.04 Disclosure of Salary Paid to Owner-Manager

Inquiry—Does FASB Statement No. 57 require disclosure of the salary paid to an individual who is both a member of management and a principal stockholder?

Reply—FASB Statement No. 57, paragraph 2 explicitly excludes “compensation arrangements.”

The exclusion in paragraph 2 applies when an individual is an owner-manager. Therefore, the salary paid to the owner-manager does not have to be disclosed under FASB Statement No. 57. [Amended]

.05 Loans to Bank Officers and Directors

Inquiry—A bank makes loans to its officers and directors. Does FASB Statement No. 57 require the bank to disclose the loans?

Reply—The fact that a bank’s business is to make loans does not change the disclosure requirements of FASB Statement No. 57.

A bank should disclose loans to officers, directors, and employees when these loans are material individually or in total. [Amended]

.06 Exchange of Interest Bearing Note for Non-Interest Bearing Note

Inquiry—Corporation A has an interest bearing note receivable from an officer/shareholder. Corporation A plans to exchange the present note for a non-interest bearing note. Should the non-interest bearing note be discounted in accordance with APB Opinion No. 21?

Reply—Yes. The non-interest bearing note should be discounted in accordance with APB Opinion No. 21, and there should be recognition of compensation or a dividend distribution, depending on what the unstated right or privilege represents.

»»»→ *The next page is 7401.* ←«««

Section 7500

Estates and Trusts

.01 Trust Funds for Perpetual Care of Cemetery

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

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

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

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

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

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

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

➤→ *The next page is 7431.* ←➤

Section 7600

Business Combinations **—General**

.01 Date of Acquisition of a Company

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

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

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

Paragraph 93 of APB Opinion No. 16, states:

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

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

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

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

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

.02 Date of Consummation of a Business Combination

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

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

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

.03 Financial Statement Presentation of Agreement to Acquire Company

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

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

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

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

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

.04 Conditions for Pooling of Interests Method

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

Condition "a" of this paragraph requires:

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

Condition "g" requires:

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

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

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

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

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

.05 Accounting for Acquisition Costs Incurred in Merger

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

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

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

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

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

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

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

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

The costs incurred by Corporation A should have been considered as part of the cost of investment and not necessarily capitalized and amortized separately.

.06 Exchange of Stock Involving Companies Under Common Control

Inquiry—Individual Y owns 100% of Corporation A and Corporation B. Individual Y exchanges his stock in Corporation A for 100 additional shares in Corporation B, thus creating a parent-subsidiary relationship. Prior to this transaction the assets, liabilities, and stockholders' equity of A and B were as follows:

<u>Company A</u>	
Assets	\$500,000
	<u><u> </u></u>
Liabilities	\$100,000
Common stock, no par value, 200 shares authorized and issued	100,000
Retained earnings	300,000
	<u> </u>
Total	<u><u>\$500,000</u></u>

<u>Company B</u>	
Assets	\$ 50,000
	<u><u> </u></u>
Liabilities	\$ 20,000
Common stock, no par value, 1,000 shares authorized, 100 shares issued and outstanding	20,000
Retained earnings	10,000
	<u> </u>
Total	<u><u>\$ 50,000</u></u>

How should Company B account for and record this transaction?

Reply—The exchange would be accounted for in accordance with AICPA Interpretation No. 39 of APB Opinion No. 16, which

stipulates that an exchange of stock involving companies under common control “would be accounted for at historical cost in a manner similar to that in pooling of interests accounting.”

Company B would record this transaction as follows:

Investment in A	400,000
Common stock of B	100,000
Retained earnings of A	300,000

This entry records B’s investment in A at the carrying amount of A’s stock (\$100,000 + \$300,000). The separate account for retained earnings of A is established to emphasize that the retained earnings are not a source of dividends to B’s stockholder, as is often true in a statutory merger.

This entry also reflects the underlying theory of pooling accounting—the combining of stockholder interests concept (APB Opinion No. 16, paragraph 53)—while recognizing the separate corporate identity of the pooled subsidiary. APB Opinion No. 18 holds that the total stockholders’ equity of the parent company should equal the total stockholders’ equity shown in the consolidated financial statements. Paragraph 19 of that Opinion states, in part, “The difference between consolidation and the equity method lies in the details reported in the financial statements. Thus, an investor’s net income for the period and its stockholders’ equity at the end of the period are the same whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated (except as indicated in paragraph 19i)”.

➤→ *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?

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Reply—Noncurrent assets, other than plant, equipment and real properties, may include investments and securities that are not marketable, long-term receivables, patents and other identifiable intangible assets, leased tangible assets, etc.

.14 Value of Receivables Purchased Decreased at Closing Date

Inquiry—A purchaser of an enterprise found that the value of the accounts receivable, included in the total assets to be purchased, had decreased at the closing date of the agreement. The seller holds the buyer to the original agreement price for the business.

What is the proper treatment on the books of the purchaser for the excess paid for accounts receivable?

Reply—A bargained price measures an outlay deemed prudent by the purchaser at the time of consummating a transaction. The difference in accounts receivable should not be written off as a loss immediately. The difference either represents a claim upon the seller (which could be set up as a receivable) on the ground that a certain amount of receivables were bargained and not received, or the excess paid represents additional goodwill, a premium the purchaser was willing to pay for future profit expectations.

.15 Leasehold Improvements Acquired as Part of Purchased Assets

Inquiry—A corporation purchased the assets of a business. The contract states that the buyer is acquiring inventory, furniture and fixtures, and leasehold improvements. The seller established prices for these assets, and the excess paid was charged to goodwill. The contract stated that the sale was contingent upon the seller being able to terminate his lease and the buyer acquiring a new lease. A new ten-year lease was obtained by the buyer.

How should the leasehold improvements be recorded on the books of the purchaser?

Reply—Accounting Principles Board Opinion No. 16, paragraphs 67-68 and 88 discuss this topic. Paragraph 67 contains the general principles for ascertaining the cost of the group of assets. Paragraph 68 indicates that the cost of individual assets should be a portion of the total cost, based on their fair values. Para-

graph 88 provides some specific guidelines for determining assigned values.

The leasehold improvements should be assigned an amount following the suggestions in paragraph 88(d) on plant and equipment. Generally, this would be the current replacement cost.

.16 Amortization of Cost of Long-Term Land Leases Acquired

Inquiry—A real estate investment trust, is acquiring substantially all of the net assets of a company whose principal holdings are improved rental real estate. The combination is being accounted for as a purchase.

The assets being acquired include several favorable long-term (99 years) land leases. The amount at which these leases are being recorded was derived by taking the capitalized economic value of the property as if owned and subtracting the capitalized value of the lease to arrive at the total economic value of the lessee's interest. The depreciated value of the improvements was then deducted to determine the residual leasehold value of the land.

What would be the period of amortization of the long-term land leases under these circumstances?

Reply—Any value assigned to the leased property should not exceed the current appraised value of the property account less its residual value at termination of the lease (discounted to present value), and reduced by any favorable (to the sublessee) factors of current subleases. Such value may be amortized over the life of the lease.

.18 Acquisition of Minority Interest in Subsidiary by Either the Parent or Subsidiary Company

Inquiry—P company owns 80% of S company. How should the acquisition of the 20% minority interest by either P or S be accounted for?

Reply—Interpretation No. 26 of APB Opinion No. 16, *Accounting for Business Combinations*, "Acquisition of Minority Interest," states in part:

Paragraph 5 of APB Opinion No. 16 states, "The acquisition of some or all of the stock held by minority shareholders of a subsidiary is not a business combination, but paragraph 43 of this Opinion specifies the applicable method of accounting."

Paragraph 43 [of the Opinion] states that the acquisition of

some or all of the stock held by minority stockholders of a subsidiary—*whether acquired by the parent, the subsidiary itself, or another affiliate*—should be accounted for by the purchase method. . . . (Emphasis added.)

Therefore, the purchase method should be used to account for the acquisition of the subsidiary's minority interest by either P or S. If there is goodwill, it should be amortized in accordance with the provisions of APB Opinion No. 17, *Accounting for Intangible Assets*. Any excess of acquired net assets over cost should be accounted for in accordance with paragraph 91 of APB Opinion No. 16.

➤ *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—

Inquiry—An individual owns two corporations. It is desirable to maintain only one corporate structure, therefore the brother and sister corporations are being merged. Would the pooling of interests method be appropriate?

Reply—Paragraph 5 of Accounting Principles Board Opinion No. 16 states in part:

The term business combination in this Opinion excludes a transfer by a corporation of its net assets to a newly formed substitute corporate entity chartered by the existing corporation and a transfer of net assets or exchange of shares between companies under common control . . . such as between a parent corporation and its subsidiary or between two subsidiary corporations of the same parent.

Accounting Interpretation No. 39 to APB Opinion No. 16 illustrates the application of paragraph 5, and indicates, "The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting."

.05 Combination of Related Companies—II

Inquiry—Company A is a real estate holding corporation owning land and buildings, forty percent of which are occupied by Company B.

The shareholders of Company A are the spouses of two of the three shareholders of Company B. The third shareholder is also related by marriage to the other two shareholders of Company B and married to the daughter of one of the shareholders of Company A.

The book value of A's assets are about ten percent of those of B.

Voting preferred stock was issued to effect the merger of Company A with Company B. Company B then set up the real estate corporation as a separate division, mortgaged the property, and used the funds in its operations.

Is the merger of Company A with Company B to be treated as a pooling of interests or a purchase?

Reply—Paragraph 5 of Accounting Principles Board Opinion No. 16, *Business Combinations*, states, "The term business combination in this Opinion excludes a transfer by a corporation of its net assets to a newly formed substitute corporate entity chartered by the existing corporation and a transfer of net assets or exchange of shares between companies under common control . . . such as between a parent corporation and its subsidiary or between two subsidiary corporations of the same parent."

Interpretation No. 39 to Opinion No. 16 deals with transfers and exchanges between companies under common control. The following excerpts are from that interpretation: "In general, paragraph 5 excludes transfers and exchanges that do not in-

volve outsiders. . . . The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting." Therefore, even though voting preferred stock was issued (which would preclude a pooling under paragraph 47b of APB Opinion No. 16), the merger of A should be treated in a manner similar to a pooling of interests if the family relationship is such that the companies were deemed to be under common control. If the family relationship leads to the conclusion that the companies are not under common control, then the merger would come under the provisions of Opinion No. 16 and purchase accounting would be required. However, in the absence of evidence to the contrary, the close family relationship among the stockholders would lead to the conclusion that A and B are under common control; therefore, Interpretation No. 39 would apply, and the transaction should be recorded in a manner similar to a pooling of interests.

.06 Combination of Related Companies—III

Inquiry—The Stock of Parent Company was held by four family members. Several years ago, the operating assets of two divisions were transferred to two newly formed corporations, A and B, in exchange for their stock. One family member exchanged his Parent stock for a minority interest in A and another exchanged his Parent stock for a minority interest in B.

Early this year, A and B were combined in a pooling of interests transaction, forming AB. Recently, AB was combined with the original Parent. The 2 family members holding AB stock will receive stock of Parent. Parent has only one class of stock.

Would the treatment of the combination of AB and Parent as pooling of interest be in accordance with Accounting Principles Board Opinion No. 16?

Reply—Interpretation No. 39 of APB Opinion No. 16 dealing with business combinations involving transfers and exchanges between companies under common control states:

In general, paragraph 5 excludes transfers and exchanges that do not involve outsiders. For example, a parent company may transfer the net assets of a wholly owned subsidiary into the parent company and liquidate the subsidiary, which is a change in legal organization but not a change in the equity. Likewise, a parent may transfer its interest in several partially owned subsidiaries to a new wholly owned subsidiary, which is again a change in legal organization but not in the entity. Also, a parent may exchange its ownership or the net assets

of a wholly owned subsidiary, thereby increasing the parent's percentage of ownership in the partially owned subsidiary but leaving all of the existing minority interest outstanding.

None of the above transfers or exchanges is covered by APB Opinion No. 16. The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting.

It should be noted, however, that purchase accounting applies when the effect of a transfer or exchange is to acquire all or part of the outstanding shares held by the minority interest of a subsidiary (see paragraph 43). The acquisition of all or part of a minority interest, however acquired, is never considered a transfer or exchange by companies under common control. (See Interpretation No. 26 of APB Opinion No. 16, "Acquisition of Minority Interest.")

The case described involves companies under common control because of ownership by the parent company and family members, and, therefore, the combination should be accounted for at historical cost.

.07 Combination of Related Companies—IV

Inquiry—Corporation A acquired Corporation B in an exchange of common stock. Corporation B is owned by two individuals in the amounts of 60 percent and 40 percent of the stock issued. Corporation B owned 12 percent of Corporation A before acquisition. The two individuals who own Corporation B, own stock of Corporation A and, including their beneficial ownership through the stock which Corporation B owns in Corporation A, they own over 50 percent of Corporation A.

How would this acquisition be classified and reflected on the records of the acquiring corporation?

Reply—It is assumed that the interest in Corporation A of each of the two individuals who own Corporation B are roughly in the same proportion to each other as is their ownership of Corporation B.

Paragraph 5 of Accounting Principles Board Opinion No. 16 excludes from the definition of a business combination the transfer of net assets or exchange of shares between companies under common control. Paragraph 5 seems to apply whether the common control was exercised by a corporation or by individuals.

Although Opinion No. 16 does not address itself to the proper accounting for a combination of such companies, it would be appropriate to apply the pooling of interests method. However,

certain of the disclosures required for a pooling of interests in business combinations would not be required for mergers of companies under common control. Such combinations should reflect generally any costs of acquisition that were incurred by the joint owner, but which were not reflected on the books of the companies being combined. Interpretation No. 39 of APB Opinion No. 16 relates to transfer and exchanges between companies under common control and can be used as a basis for application of the pooling of interests method.

.08 Acquisition of a Division of Another Company

Inquiry—A company is acquiring a division of another company. Accounting Principles Board Opinion No. 16, paragraph 5, reads in part, “The conclusions of this section apply equally to business combinations in which one or more companies become subsidiary corporations, one company transfers its net assets to another, and each company transfers its net assets to a newly formed corporation.”

Is this transaction excluded from Accounting Principles Board Opinion No. 16, and, if not, what method of accounting should be used?

Reply—The first sentence of APB Opinion No. 16, paragraph 5, states, “This section covers the combination of a corporation and one or more incorporated or unincorporated businesses; both incorporated and unincorporated enterprises are referred to in this section as companies.” The division should be viewed as an “unincorporated enterprise” because whether the other company chose to operate under a divisional or parent-subsidiary structure is largely a matter of management preference and form over substance. Therefore, this acquisition is covered by APB Opinion No. 16 and the purchase method should be used.

.09 Pooling of Interest Following Abandonment of Previous Attempt to Merge

Inquiry—A year ago, Company A was acquired by Company B in an exchange of stock. A condition of this exchange was that Company B would register its stock with the SEC within one year. If such a registration was not completed, the shareholders of the two companies would again be separate, autonomous, and unrelated entities.

Company B was unable to register its stock and the exchange

of stock was subsequently reversed. Company A is now contemplating combining with another company.

One of the conditions for using the pooling of interest method for business combinations is stated in paragraph 46 of Accounting Principles Board Opinion No. 16 as follows:

Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.

Was Company A a subsidiary of Company B?

Reply—Although Company A had been involved in an attempted business combination which was abandoned after one year, the failure of the transaction would indicate that the company had not in fact been a division or subsidiary of another company. Therefore, the requirement of paragraph 46 of APB Opinion No. 16 would not preclude a subsequent business combination from being accounted for as a pooling of interest.

.10 Business Combination Following a "Spin-off"

Inquiry—A company which owns 100 percent of two subsidiaries is considering combining with another company through an exchange of stock. Prior to any combination, however, the company intends to spin-off to its present stockholders the capital stock of the two subsidiaries. These two subsidiaries account for approximately 50 percent of the gross revenue of the combined enterprise. Would the combination, after the spin-off, qualify as a pooling of interest or as a purchase under Accounting Principles Board Opinion No. 16?

Reply—Paragraph 46a of APB Opinion No. 16 states that to qualify for a pooling of interest, "each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated."

Paragraph 47c states that in order to be considered a pooling of interest, "none of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years of the date the combination is initiated or between the dates the combination is initiated and consummated; changes in contemplation of effecting the combination may include distributions to stockholders and additional issuances, exchanges, and retirements of securities."

Therefore, in accordance with paragraphs 46a and 47c of Accounting Principles Board Opinion No. 16, the transaction must be considered a "purchase."

.11 Pooling of Interest Following Acquisition of Treasury Stock

Inquiry—A company has decided that it is over-capitalized and wishes to acquire treasury shares in order to reduce its capitalization. Assuming that the number of shares acquired is material as contemplated by the Interpretation No. 20 to Accounting Principles Board Opinion No. 16, will the company be precluded from entering pooling of interest business combinations for a period of two years? If the company decides to accomplish this reduction in capitalization by a pro rata redemption of outstanding shares, is it similarly precluded from entering pooling of interests business combinations for two years?

Reply—Interpretation No. 20 relates to paragraphs 47(c) and (d) of APB Opinion No. 16.

Paragraph 47(d) states, "Each of the combining companies reacquires shares of voting common stock only for purposes other than business combinations, and no company reacquires more than a normal number of shares between the dates the plan of combination is initiated and consummated." In determining intent, both in subparagraphs (c) and (d) of paragraph 47 and subparagraph (a) of paragraph 46, it is presumed that a transaction is in contemplation of the business combination if it occurs within two years prior to the initiation of the plan.

As stated in the Interpretation to APB Opinion No. 16, paragraph 47(d), this presumption may be overcome if it is shown that the shares have been or will be reissued in stock option or other compensation plans or as payments in purchase combinations. It will also be overcome if the stock is resold prior to the business combination.

However, if the stock is not reissued, it should be evident that some of the stockholders are being paid in cash, rather than receiving stock of the combined company or that some stockholders have been paid in cash for part of their stock. APB Opinion No. 16 expressly precludes pooling of interests accounting when stockholders of either of the combining companies are paid in part by cash.

The Interpretation of APB Opinion No. 16, paragraph 47(d),

lists specific purposes for acquiring treasury stock which would not prohibit pooling of interests accounting treatment: stock option or compensation plans, stock dividends declared, "purchase" business combinations, and resolving existing contingent share agreements from a prior business combination. Each of these purposes is similar in that they all include a subsequent distribution of the stock. In other words, the company is re-acquiring the stock for some subsequent business purpose. "Over-capitalization" as a specific purpose differs from these examples because the company is not acquiring these shares for a subsequent business purpose.

Therefore, treasury stock acquisitions to avoid over-capitalization is a business purpose which will prevent pooling of interests accounting for business combinations for two years. This assumes that the violation has not been "cured" by resale of these shares prior to consummation.

A pro rata redemption of shares is, in substance, the same as an acquisition of treasury stock. Accordingly, the company will also be ineligible to enter pooling of interests business combinations for two years if it chooses this method to reduce its capitalization.

Also see the SEC's Codification of Financial Reporting Policies, Sec. 201.02 (ASRs 146 and 146A).

.12 Exchange of Shares Between Companies Under Common Control

Inquiry—The voting common stock of Corporations A and B are owned by the same interests but not in the same proportion. In addition, B has outstanding nonvoting common stock which is identical to the voting common stock, except for the voting privilege. None of the holders of the voting stock own nonvoting stock, although members of their families and family related trusts are owners of part of the nonvoting stock with the balance being held by key employees and others. It is proposed that B remain in existence but that all of its voting stock be acquired by A in exchange for voting stock of A. The nonvoting stock will not be exchanged.

Based upon current financial statements, the nonvoting interest in B represents approximately 35 percent of the stockholders' equity in that corporation and would represent approximately 20 percent of the combined stockholders' equity.

What is the proper accounting for the combination of these two companies?

Reply—Paragraph 5 of APB Opinion No. 16 excludes from the term “business combination” an exchange of shares between companies under common control. Such a combination, although thus excluded from the provisions of APB Opinion No. 16, should generally be accounted for in the same manner as a pooling of interests. Even if the combination of the two companies should be considered a business combination subject to Accounting Principles Board Opinion No. 16, allowing the nonvoting stock of one of the companies to remain outstanding would not result in a business combination being accounted for as a purchase, if all other conditions indicated use of the pooling method. Interpretation No. 39 of APB Opinion No. 16 discusses transfers and exchanges between companies under common control.

.13 Effect on Pooling of Interests of Contingently Issued Shares Held in Escrow

Inquiry—A client and another company have agreed to a plan of combination which is intended to meet all of the criteria for pooling of interests accounting.

The client’s attorneys have prepared a preliminary draft of an indemnity-escrow agreement which may provide for deposit in escrow of 30 percent of the total shares to be issued to affect the combination, to secure, compensate, and indemnify the issuer regarding breach of certain warranties and other matters coming within the type of “general management representations” as referred to in Interpretation 30 to Accounting Principles Board Opinion No. 16.

One of the requirements stated in paragraph 47 of APB Opinion No. 16 is:

- g. The combination is resolved at the date the plan is consummated and no provisions of the plan relating to the issue of securities or other consideration are pending.

This condition means that (1) the combined corporation does not agree to contingently issue additional shares of stock or distribute other consideration at a later date to the former stockholders of a combining company, or (2) the combined corporation does not issue or distribute to an escrow agent common stock or other consideration which is to be either transferred to common stockholders or returned to the corporation at the time the contingency is resolved.

An agreement may provide, however, that the number of shares of common stock issued to effect the combination may be revised for the later settlement of a contingency at a different amount than that recorded by a combining company.

Interpretation No. 14 to APB Option No. 16 states:

The only contingent arrangement permitted under paragraph 47-g is for settlement of a contingency pending at consummation, such as the later settlement of a lawsuit. A contingency arrangement would also be permitted for an additional income tax liability resulting from the examination of "open" income tax returns.

Interpretation No. 30 states:

The most common type of contingency agreement not prohibited in a pooling by paragraph 47-g is the "general management representation" which is present in nearly all business combinations. In such a representation, management of a combining company typically warrants that the assets exist and are worth specified amounts and that all liabilities and their amounts have been disclosed. The contingency agreement usually calls for an adjustment in the total number of shares exchanged up to a relatively small percentage (normally about 10%) for variations from the amounts represented, but actual adjustments of the number of shares are rare.

Would the 30 percent of the shares to be issued held in escrow preclude the use of the pooling of interests method?

Reply—The contingencies covered in Interpretation No. 14 are more susceptible of quantification than those discussed in Interpretation No. 30. The 10 percent referred to in No. 30 should not be viewed as a ceiling if the escrow shares are earmarked for contingencies, such as those discussed in No. 14. However, No. 30 also states:

. . . the contingency agreement is merely a device to provide time for the issuing company to determine that the representations are accurate so it does not share risks arising prior to consummation. Although the time required will vary with circumstances, these determinations should be completed within a few months following consummation of the combination. In any case, the maximum time should not extend beyond the issuance of the first independent audit report on the company making the representations following consummation of the combination.

.14 Issuance of Stock for Contingent Earnings Rights of Acquired Company's Stockholders

Inquiry—Corporation A plans to combine with Corporation B, with A being the surviving corporation. A will issue its shares of stock to the stockholders of B. B also has a preexisting obligation

to certain of its shareholders who have certain contingent earnings rights requiring issuance of additional common stock. Corporation A has agreed to assume this obligation and will issue shares of its own stock to these stockholders. May this merger be treated as a pooling of interest?

Reply—The issuance of A's common shares to the holders of the contingent earnings rights would not prohibit using the pooling of interests method to account for the business combination. Issuing common stock for this obligation is similar to assuming or exchanging common stock for a debt security. Therefore, it would be proper to apply that part of APB Opinion No. 16, paragraph 47, which states, “. . . a corporation issuing stock to effect the combination may assume the debt securities of the other company or may exchange substantially identical securities or voting common stock for other outstanding equity and debt securities. . . .”

.15 Pooling of Interests Precluded by Agreement to Redeem Stock

Inquiry—Corporation A, a personal holding company, has an agreement with its sole shareholder to redeem the corporation's stock at fair market value on the date of the shareholder's death.

Corporation B, whose stock is publicly traded, proposes to merge with A. All stockholders will exchange their stock for voting common stock in the resulting Corporation AB.

Assuming that the exchange of stock meets all other requirements for a pooling of interests, would the assumption of the redemption agreement by AB negate the pooling under the “contingent bailout” or “planned transaction” provisions of Accounting Principles Board Opinion No. 16?

Also, if pooling is permissible, would the result be changed if AB amended the agreement to provide a specific redemption price not related to the fair market value of the stock at the death of A's shareholder?

Reply—Paragraphs 48a and 48b of APB Opinion No. 16 specify that a combined corporation may not agree to retire or reacquire any of the common stock issued to effect the combination or enter into financial arrangements for the benefit of the former stockholders of a combining company if a business combination is to be accounted for by the pooling of interests method. Furthermore, Interpretation No. 21 of the Opinion states, in part,

that the critical factor in meeting the conditions of paragraphs 48a and 48b of the Opinion is that the voting common stock issued to effect a business combination remains outstanding outside the combined corporation without arrangements on the part of any of the corporations involving the use of their financial resources to "bailout" former stockholders of a combining company or to induce others to do so.

These references lead to the conclusion that pooling of interests accounting would not be permitted under these circumstances despite the preexistent aspect of the agreement with A's sole stockholder.

.16 Purchase of Treasury Stock Between Date of Initiation and Consummation of Business Combination

Inquiry—In connection with its initial public offering more than one year ago, a company issued to the underwriters five-year warrants to purchase voting common shares at the same price the shares were issued to the public. The company wishes to purchase now, or from time to time as it deems prudent, the aggregate number of common shares for which warrants are outstanding. The company intends to specifically reserve those shares in its treasury for such purpose and to reissue them for the warrants exercised. Would such repurchases of voting common stock for the treasury between the date of initiation and consummation of a business combination destroy what would otherwise have been a transaction accounted for by the pooling of interests method?

Reply—Paragraph 47d of Accounting Principles Board Opinion No. 16 states, "Each of the combining companies reacquires shares of voting common stock only for purposes other than business combinations, and no company reacquires more than a normal number of shares between the dates the plan of combination is initiated and consummated." Interpretation No. 20 to APB Opinion No. 16 states in part:

The statement "for purposes other than business combinations" means combinations initiated under APB Opinion No. 16 which are to be accounted for by the pooling of interests method. Therefore, acquisitions of treasury stock for specific purposes that are not related to a particular business combination which is planned to be accounted for by the pooling of interests method are not prohibited by the conditions of either paragraph 47-c or 47-d.

In the absence of persuasive evidence to the contrary, however, it should be presumed that all acquisitions of treasury stock during the

two years preceding initiation and consummation were made in contemplation of effecting business combinations to be accounted for as a pooling of interests. . . . Treasury shares reacquired for these purposes should be either reissued prior to consummation or specifically reserved for those purposes existing at consummation.

In this case the company is reacquiring the shares for the specific purpose of meeting its commitments in connection with the warrants issued to the underwriters and intends to reserve the treasury shares so acquired specifically for reissuance in connection with those warrants. Therefore, taking paragraph 47d and the interpretation together, acquisition of voting common stock to be reserved and used for the purpose of satisfying the client's commitments in connection with the warrants issued to the underwriters would constitute the acquisition of treasury stock "for purposes other than business combinations" and would not preclude the use of pooling of interests accounting for a pending business combination which otherwise meets all of the conditions specified in APB Opinion No. 16.

➡ *The next page is 7831.* ←

Section 7630

Application of Pooling of Interests Method

.01 Individual Status of a Corporation in a Pooling of Interests

Inquiry—Accounting Principles Board Opinion No. 16 states in paragraph 47:

A transfer of net assets of a combining company to effect a business combination satisfies condition 47-b provided all net assets of the company at the date the plan is consummated are transferred in exchange for stock of the issuing corporation.

If net assets are transferred in exchange for stock, what happens to retained earnings of the combining corporation? Does that corporation retain its individual status as a separate corporation with its primary asset being the stock received for the net assets transferred?

Reply—This part of paragraph 47 of APB Opinion No. 16 is directed toward accounting for a business combination in which one company transfers its net assets to another or in which each company transfers its net assets to a newly formed corporation, and which is treated as a pooling of interests.

Where this occurs, the accounting for the company resulting from the combination should be the same as though stock had been transferred—that is, the retained earnings of each of the companies should be included as retained earnings of the combined company, except to the extent that higher par value of the stock issued may result in capitalizing retained earnings.

Opinion No. 16 is directed toward accounting for the combination, rather than for the individual companies being combined. However, if the stock received by a combining company for its assets was not distributed pro rata to its shareholders, the provisions of paragraph 47e, of the Opinion would not be met, and the combination could not be accounted for as a pooling of interests.

.02 Exchange of Stock on a Share for Share Basis with Different Stated Values

Inquiry—Corporation A merged with Corporation B, leaving Corporation A as the survivor. The terms of the merger stated

that the shareholders of Corporation B would exchange their stock on a "share for share basis" for the stock of Corporation A. The stock of Corporation B has a stated value and was sold originally at \$.05 per share, but the stock of Corporation A has a stated value of \$.10 per share. When Corporation A issued its stock for Corporation B's stock on a "share for share basis," the net effect resulted in Corporation A's stock being issued at a discount of \$.05 per share.

What is the proper statement presentation for this transaction?

Reply—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.

➤→ *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 should show a single balance sheet caption and amount. The components of retained earnings (pre-election accumulations, previously taxed income, undistributed taxable income) may be disclosed in the notes to

the financial statements or supplementary information if it is meaningful to users of these financial statements. [Amended]

.04 Reversal of Timing Difference After Termination of Subchapter S Election

Inquiry—As a Subchapter S Company not subject to federal income taxes, Company A did not provide deferrals for the tax effects of timing differences. Subsequently, Company A terminated its Subchapter S election. Should the deferred income taxes attributable to the timing differences be reinstated? If so, at what rate? Should it impact the beginning retained earnings?

Reply—There is no authoritative literature on this particular subject. Some accountants believe that the appropriate deferred income taxes should be reinstated at the rate that was in effect when the timing difference originated. The cumulative effect of this reinstatement would be reported in the current year's statement of income with appropriate disclosure. Accordingly, the reinstatement would not impact the beginning retained earnings. Any timing differences for the current year (termination of election) and thereafter would be reported in accordance with APB Opinion No. 11.

Other accountants believe that reinstatement of deferred income taxes should not be reported as of the termination of the Subchapter S election and only timing differences in the year of termination and thereafter should be recorded. Those who advocate this position would consider timing differences originating while the Subchapter S election was in effect and reversing when the election was terminated as permanent differences.

➡ *The next page is 8011.* ←

Section 7920

Domestic International Sales Corporations

.01 Accounting for a Domestic International Sales Corporation Subsidiary

Inquiry—In a Domestic International Sales Corporation (DISC), one half of the earnings are required to be distributed back to the parent company, but the remaining one half may be retained by the subsidiary untaxed. How should the income of a DISC subsidiary be reported in the parent's financial statements under the equity method of accounting for subsidiaries?

Reply—A DISC subsidiary should be accounted for in the same manner as any other subsidiary. Paragraph 19(c) of Accounting Principles Board Opinion No. 18 states:

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

A caption commonly used is "equity in earnings of unconsolidated subsidiaries." If the subsidiary has items of extraordinary income or expense, the words "before extraordinary items" should be inserted. If this is the only unconsolidated subsidiary it might be called "equity in earnings (before extraordinary items) of domestic international sales corporation subsidiary."

The investor's share of the earnings of a DISC subsidiary would include the entire earnings of the subsidiary. The parent should include in its provision for income taxes (rather than as a deduction from its equity in the subsidiary's income) appropriate taxes on income of the subsidiary, after allowing for any dividend credits, etc.

Paragraph 12 of APB Opinion No. 23 states that if there is sufficient evidence to indicate that there will be indefinite postponement of the distribution of earnings of the subsidiary or that such earnings will be remitted without incurring a liability for taxes, no deferred taxes should be provided on such income until it becomes apparent that such earnings will become taxable. Generally, it would be appropriate to so postpone any provision for income taxes on 50 percent of earnings of DISC subsidiaries.

Postponement would require the disclosures referred to in paragraph 14 of APB Opinion No. 23.

.03 Sales to Domestic Companies Classified as Export Sales

Inquiry—Company A, a domestic manufacturer with a DISC subsidiary, sells manufactured goods to unrelated domestic companies under agreements which assure that the goods will be sold in the export market. Such agreements are necessary to qualify the sales as export sales under DISC regulations. Are such sales “export sales” as contemplated by FASB Statement of Financial Accounting Standards No. 14?

Reply—Such sales may be considered “export sales” under FASB Statement No. 14 because the buyers have agreed that the goods will be exported.

TIS Section 8000

AUDIT FIELD WORK

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➤➤➤→ *The next page is 8321.* ←➤➤➤

Section 8100

Planning and Supervision

.01 Use of Standardized Audit Program

Inquiry—A publishing house sells a preprinted audit program. May a CPA use such an audit program?

Reply—It is not generally desirable to begin a job with a pre-designed audit program unless the program is designed for the specific industry involved. Such a program would either include voluminous material not applicable to the majority of engagements, or the program would require extensive additional material. In the latter case, the danger of omitting significant audit procedures would appear greater with a preprinted program than if a program were designed for the particular engagement.

The standard auditor's opinion calls for application of "such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances." For an auditor to rely on determination by someone else of the procedures considered necessary in the circumstances would cast doubt as to whether he is exercising due professional care in the performance of the examination.

»→ *The next page is 8371.* ←«

Section 8200

Internal Control

.02 Determining Accuracy of Cash Collections for Coin-Operated Machines

Inquiry—How can the accuracy of the cash collections be determined for a chain of laundromats with several thousand machines? The coin-operated machines do not employ the use of meters, counters, locked boxes, or any other devices that would provide a basis for control.

Reply—One method to determine if the machines' receipts are being surrendered intact is to occasionally fill selected coin-operated machines with marked coins. The subsequent collections can then be reviewed to make sure the same coins have been turned in. It may also be possible to correlate revenues with consumption of water and electricity by these machines. Furthermore, it may be possible to determine the expected revenues from an installation and the extent to which the machines are being used by observation of the activities of selected installations.

►→ *The next page is 8471.* ←◄

Section 8210

Statistical Sampling

.02 Selection of the Sampling Unit

Inquiry—Should a voided check be included as one of the sampling units?

Reply—Whether or not to include voided checks depends on what is being sampled. If an auditor is sampling “all payments made during the period”, a voided check is not evidence of a payment and should not be included. If an auditor is sampling “all checks processed during the period”, a voided check is evidence of a processed check and should be included.

➡ *The next page is 8521.* ←

Section 8310

Evidential Matter: Securities

.01 Reliance on Report of Custodian of Securities

Inquiry—A bank acts as a custodian for the securities investments of a client. The bank furnishes the client with monthly reports showing all transactions such as sales, purchases, interest and dividends received, and the current market value of the investments. Can the auditor rely on this custodial report, or must the securities be physically examined?

Reply—Whether the custodial report of the bank, supplemented by direct correspondence from the bank to the auditor, is adequate evidence of the existence and ownership of the investment securities held by the bank would depend primarily on the relationship between the value of the securities held and the financial resources of the bank.

It is usual practice where such investments are held in an amount which is not material to the resources of the bank to accept a confirmation of responsibility by the bank as adequate evidence of existence of the asset.

Where the value of the securities is material in relation to the resources of the bank, it may be necessary to visit the bank to determine that the securities are held in the name of the investing company, or if held in “street” name or in the name of the bank that the securities are in fact segregated. The bank will usually have an internal document attached to each such certificate (or group of certificates) indicating the owner for which they are held. Prior arrangements may be made by the client with bank authorities so that the auditor may, on a surprise basis, go to some officer of the bank and be led directly to the vault to examine the shares certificates and the evidence that such certificates are held for the client.

If such physical examination of the securities is necessary, it will frequently be appropriate to reconcile (possibly on a test basis) the certificate numbers of securities held with certificate numbers held at the date of the preceding examination, adjusted for subsequent sales and purchases.

.02 Confirmation of Securities Held in Street Name

Inquiry—A CPA firm has been engaged to perform the initial audit of a pension plan and trust. Most of the trust assets are investments held in street name by a brokerage house. Some negotiable bearer bonds, held in a bank, are in denominations not traceable to the trust account since the bond may represent investments by more than one customer. In addition to its monthly account statements the broker will certify details and ownership of investments at the statement date and will permit examination of certain of its internal records. The bank will also certify details and ownership of investments held for the trust.

Would the fact that the securities are held in “street name” and in some cases in denominations which cannot be traced to the trust’s account preclude obtaining sufficient competent evidential matter on which to base an opinion on the financial statements of the pension plan and trust?

Reply—Statement on Auditing Standards No. 31 discusses evidential matter. Physical inspection and count of the securities in this case appear to be impracticable; therefore, evidential matter concerning the securities would presumably consist primarily of confirmations received from the brokerage houses and other financial institutions which have possession of the securities. Whether or not confirmations would represent sufficient evidence is really a matter for the auditor’s professional judgment. [Amended]

➤→ *The next page is 8571.* ←⚡

Section 8320

Evidential Matter: Inventories

.01 Reliance on Observation of Inventories at an Interim Date

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

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

Reply—Section 331.09-.12 of Statement on Auditing Standards No. 1 discusses evidential matter regarding inventories. Section 331.10 of SAS No. 1 states, “When the well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, the auditor’s observation procedures usually can be performed either during or after the end of the period under audit.” Section 331.12 states in part, “. . . it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate test of intervening transactions.”

Normally, observing an inventory-taking on December 31 when a client has a March 31 year-end and perpetual records are used as the basis of the March 31 inventories, would present no unusual problems since the tests of intervening transactions referred to in section 331.12 usually can be readily applied. However, if the client keeps no perpetual records of inventory, the tests of the intervening transactions would, in effect, cause the auditor to create the perpetual records as a basis for the March 31 inventory.

.02 Observation of Physical Inventory on a First Audit

Inquiry—A company maintains large inventories of tractor parts in five different locations. The quantities of each part may be quite small, averaging six or seven pieces; but there are approximately 5000 different parts on hand, some as much as twenty years old. The company has been taking complete physical

inventories at the end of each year. In the past, the parts inventories have been valued at the current catalogue prices.

A CPA has been engaged to perform the company's first audit. What procedures may be followed in establishing the value of the parts inventory?

Reply—It would appear necessary under sections 331.01-.09 of Statement on Auditing Standards No. 1 and paragraphs 10-13 of SAS 2 that the auditor observe the client's count of the parts inventory. Presumably tests should be made in each of the five locations.

Inventory pricing should be based on historical cost, rather than current selling price. While it may not be practicable to determine cost individually for the large number of parts on hand, it might be appropriate to determine the ratio of cost to catalogue price to obtain an approximation of the cost of current inventory. Also, some allowance, based on experience, should be made for obsolescence. Presumably a part will have little current value if there is a probability it will not be sold within five years. Costs of warehousing items for such a period may often approach the discounted value of the sales price.

Based upon observations and upon discussions with the client's employees, the auditor may be able to obtain some impressions as to the reliability of the earlier inventories. This would be supported by a comparison of this year's inventory with the prior year's, and by knowledge of sales and production in the current year.

.03 Cost of Inventories Acquired from Principal Stockholder

Inquiry—A corporation purchased merchandise from a stockholder who owns 99 percent of the corporation's stock and executed a chattel mortgage in favor of the stockholder. The merchandise was acquired by the stockholder prior to the formation of the corporation.

How can the CPA be sure the purchase price of this merchandise is reasonable?

Reply—The "seller's" cost can be ascertained through the examination of his cost records, invoices, etc., and comparing his total cost with the selling price to the corporation. Also, the taking of inventory can be observed and verified against physical quantities and classifications of inventory, against transfer docu-

ments and against the transferor's cost records and invoices. If the latter records are not available, the auditor can price the inventory at the current replacement cost which can be obtained by reference to recent invoices, communication with suppliers, or references to recent merchandise catalogs.

A basic consideration in this case is the fact that, upon incorporation, there is a continuance of beneficial interest in the inventory transferred and in the proceeds from its eventual disposition by virtue of the chattel mortgage and the 99 percent stock ownership. Accordingly, the transferor's cost should be carried over and continued on the books of the newly organized corporation.

.04 Reliance on Estimates of Coal Inventories by Experts

Inquiry—An electric utility maintains a large stockpile of coal. The auditors rely on the calculations of an engineering firm in their test of this inventory. The amount of coal by weight is estimated by multiplying the volume of the coal pile, calculated in cubic feet, by the estimated average density of the coal, measured in pounds per cubic foot. The calculated amount is then compared with the utility's perpetual inventory records, and, if the variance is not considered material, the perpetual inventory is accepted as the accurate amount.

Because of the uncertainties involved in this method, particularly in the estimation of the average density of the coal, the engineers are reluctant to render an opinion on the amount of coal on hand. Other methods of calculating the amount of coal such as the "two coal-pile" theory are uneconomical.

In all cases, this inventory is a material item in the accounts of the utility. What alternative auditing procedures might be used in these circumstances?

Reply—While a slight change in density of the coal might result in a change in computed quantity of coal on hand, the effect would most likely not be material in relation to the balance sheet or statement of operations of the utility company. Perhaps, using the criteria of statistical sampling, the engineers would be willing to state that there is a X% probability that the quantity of coal is a certain amount plus or minus X% (or some other measure of variability).

.05 Dates of Observation of Inventories Which Are Kept on Perpetual Records

Inquiry—A retail dealer in tires and tubes has twenty-two stores. Each month the dealer takes inventory at two stores. The dealer's auditor has observed the inventory taking at ten locations. To avoid the need for extra help at year end, January 31, the auditor proposes to visit the remaining locations shortly after December 31 and:

- Count the tires on hand at that time
- Reconcile the count back to the daily report at December 31.

Do the above described procedures constitute an adequate observation of inventories?

Reply—Section 331.09-15 of Statement on Auditing Standards No. 1 discusses evidential matter for inventories. Section 331.10 states:

When the well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, the auditor's observation procedures usually can be performed either during or after the end of the period under audit.

Presumably the dealer has the necessary perpetual records which allow the taking of inventory at two stores each month during the year. Therefore, the proposed procedures would be acceptable and meet the requirement for inventory observation.

.06 Observation of Consignment Inventories Stored in Public Warehouse

Inquiry—Corporation A sells supplies and equipment for manufacturing jewelry. Silver on consignment from a supplier is kept in a vault adjacent to where Corporation A keeps its silver inventory. The supplier employs an independent warehouse firm to protect the consigned silver. The bonded employee of the warehouse firm has sole access to the consignment silver and performs the duties of warehouse manager for Corporation A. The warehouse firm pays the salary of the bonded employee but is reimbursed by Corporation A. Since the possibility for substitutions between Corporation A's silver inventories and the consignment silver exists, the auditors of Corporation A, in conducting a physical observation of Corporation A's silver inventories, also want to conduct a physical

observation of the consignment silver. Is it necessary for the auditors of Corporation A to observe the consignment silver?

Reply—SAS No. 1 section 331.14, and SAS No. 1 section 901.24—.28 (as amended by SAS No. 43) deal with controls and auditing procedures for owner's goods stored in public warehouses. Section 901.28 makes reference to section 331.14 which provides that obtaining direct confirmation from the custodian is acceptable, except that supplemental procedures are to be applied in cases where such inventories represent a significant proportion of the client's current assets or total assets. Among the steps recommended for the auditor to follow, to the extent considered necessary, is the observation of physical counts of the goods wherever practicable and reasonable.

Because of the relationship which Corporation A has with the warehouse and the bonded employee, and the possibility for substitutions of inventory between Corporation A and the supplier, the auditors should observe the consignment inventory and Corporation A's inventory at the same time. [Amended]

➤➤➤ *The next page is 8671.* ←➤➤➤

Section 8330

Evidential Matter: Fixed Assets

.01 Verification of Real Estate Ownership

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

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

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

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

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

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

.02 Examination of Assets of a Rental Company

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

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

»—> *The next page is 8731.* ←«

Section 8340

Evidential Matter: Confirmation Procedures

.01 Confirmation of Factored Receivables

Inquiry—When accounts receivable are sold to a factor under a factoring agreement, is confirmation of these receivables necessary?

Reply—The AICPA Industry Audit Guide, *Audits of Finance Companies* (1973), discusses factoring arrangements on pages 12-14 and 108-109. As indicated in the guide, the factor assumes the credit checking, bookkeeping, and collection responsibilities of his client and generally assumes the credit risk, unless the account is purchased on a recourse basis, under which arrangement, the credit risk remains with the client. Under either arrangement, the client remains contractually responsible for any claims or disputes with the customer.

For financial reporting purposes, purchased receivables are shown as an asset in the factor's balance sheet and the unpaid portion of the purchase price as a liability "due to clients." Overadvances sometimes granted to clients, and generally secured by other assets such as inventory and fixed assets, are segregated from purchased receivables and reported as "due from factored clients."

Since the audit guide indicates that the purchased receivables are shown as assets on the factor's balance sheet, it seems that the factor's auditors should confirm these receivables in accordance with Sections 331.03-331.08 of Statement on Auditing Standards No. 1. If the receivables are purchased on a nonnotification basis, the factor's auditors may request their customer's auditors to confirm the balances in the customer's name because the debtors would have no knowledge that their accounts had been factored.

.02 Confirmations of Receivables From Governments and Large Corporations

Inquiry—It is often difficult to get replies to confirmation re-

quests from large corporations and governmental agencies. What procedures can be followed to confirm these accounts?

Reply—The problems of obtaining confirmation of receivables from large multi-office corporations as well as from various government agencies generally involves identifying the individual who is in a position to give assurance as to the validity of the receivable. Very frequently this will make impossible confirmation of all receivables from a particular company by one confirmation request. However, by limiting the test of the receivables from any such company to a fair sampling, by identifying the voucher numbers or order numbers involved, and by care in selecting the accounting center and possibly the individual to whom a request is sent, it is sometimes possible to obtain confirmation of an appropriate number of items from each such account despite the form letter that is sent out in reply to a request for confirmation of the overall balance due, a company is generally willing to respond to a request which can be answered without an undue amount of research.

There may, however, be occasions on which the company will not respond to confirmation requests. In such instances if remittance advices are obtained, they usually will adequately identify a remittance so that it can be related directly to the invoice against which it is being applied. If the auditor is satisfied that the date of receipt of the accompanying remittance was subsequent to the cut-off date for examination of receivables, this will frequently be an application of “other auditing procedures” adequate to meet the requirements of paragraph 12 of Statement on Auditing Standards No. 2.

.03 Confirmation of Balances Due on Loans

Inquiry—A bank arranges mortgage loans whereby the borrower instructs the bank to make payments to the contractor or developer. Payment booklets, which specify the periodic amounts due, are sent twice yearly to the borrower. In addition, each borrower receives an annual statement which shows his total yearly payments as well as the various yearly charges. Many of the debtors are unable to verify the correctness of the accrued charges and are unable to check the outstanding balances of their loans because of the complex interest rates. How can these loan balances be confirmed when the debtor can not determine the total amount of the debt?

Reply—While the debtor may not be able to calculate the balance of the loan due, there are details of the loan which he should know and which can be confirmed. A request that the debtor confirm the original amount of the loan and the payments he has made would properly serve the purpose of a confirmation. Confirmation of the interest rate might also be requested as this affects the balance of the loan and should be known by the debtor.

.04 Reporting Additional Paid-up Insurance on Standard Confirmation Inquiry

Inquiry—The *Standard Confirmation Inquiry for Life Insurance Policies* made available by the AICPA does not appear to have a place for including “additional paid-up insurance” which is usually acquired by the owner with policy dividends. How should this item be confirmed?

Reply—One of the original drafts of the confirmation form did provide for additional paid-up insurance, but it was deleted as nonessential since the primary purpose of the form is to determine the cash surrender value of the policies. As the form is currently constructed, the information regarding additional paid-up coverage would appear at item No. 1, although “face amount of basic policy” does not really describe it accurately, and an insurance company might misinterpret the request.

.05 Confirmations for a Broker or Dealer in Commodity Options

Inquiry—AICPA 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.

.10 Letter of Inquiry to Client's Attorney

Inquiry—When a CPA requested a client to send a letter of inquiry to the client's attorney, the client objected because the attorney would charge for answering the letter of inquiry. The client also believed that an inquiry about legal matters was not valid.

The client reported that no legal problems were pending for the year under audit, but currently litigation was possible. Do generally accepted auditing standards require that the client send a letter of inquiry to an attorney?

Reply—Generally accepted auditing standards as set forth in SAS No. 12 require that a letter of inquiry be sent to an attorney if the auditor has knowledge that an attorney has been consulted. If the auditor has no evidence of outstanding legal matters, and the client has not consulted an attorney, the auditor is not required to confirm with a consulting attorney the absence of litigation.

.11 Receivables in Cash Basis Financial Statements

Inquiry—If accounts receivable and escrow balances are included in modified cash basis financial statements, should the accounts receivable and escrow balances be confirmed?

Reply—The generally accepted auditing standards, including confirmation, that apply to financial statements prepared in conformity with generally accepted accounting principles apply to modified cash basis financial statements.

.12 Letter of Inquiry to Client's Attorney Concerning Unasserted Claims

Inquiry—SAS No. 12, Appendix A, presents an illustrative audit inquiry letter to be sent to legal counsel if unasserted claims and assessments exist. Auditing Interpretation, "Form of Audit Inquiry Letter When Client Represents that No Unasserted Claims and Assessments Exist" specifies how to revise the illustrative audit inquiry letter if unasserted claims and assessments do not exist. The Interpretation states:

Unasserted claims and assessments—We have represented to our auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed, in accordance with FASB Statement No. 5. (The second paragraph in the section relating to unasserted claims and assessments would not be altered.)

Which paragraph is the second paragraph that the Interpretation refers to?

Reply—The second paragraph in Appendix A is the paragraph that starts with “We understand that whenever . . .” That paragraph alerts legal counsel of the client’s understanding of legal counsel’s professional responsibilities and may prompt legal counsel to advise the client of unasserted claims and assessments that the client has not brought to the attention of the auditor.

.13 Negative Confirmations

Inquiry—Is it acceptable to use only negative accounts receivable confirmations?

Reply—SAS No. 1, section 331, *Receivables and Inventories*, describes the use of negative and positive confirmations. Paragraph 5 states:

Because the use of the positive form results in either (a) the receipt of a response from the debtor constituting evidence regarding the debt or (b) the use of other procedures to provide evidence as to the validity and accuracy of significant non-responding accounts, the use of the positive form is preferable when individual account balances are relatively large or when there is reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. The negative form is useful particularly when internal control surrounding accounts receivable is considered to be effective, when a large number of small balances are involved, and when the auditor has no reason to believe the persons receiving the requests are unlikely to give them consideration.

Paragraph 5 also indicates that if negative rather than positive confirmations are used, it is normally necessary to send more requests or to perform more extensive auditing procedures to obtain reasonable assurance with respect to the accounts receivable balances. Accordingly, a combination of positive and negative confirmations is frequently used in practice.

➤→ *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.

.03 Obtaining Written Representation from Management

Inquiry—SAS No. 19 requires an auditor to obtain a written representation from management. If an auditor believes that a written representation from management is not essential to express an opinion on the financial statements examined and consequently does not obtain the written representation, can the auditor express an unqualified opinion?

Reply—If an auditor states in his report that he is expressing an opinion based on an examination made in accordance with generally accepted auditing standards, he would be unable to express an unqualified opinion unless he obtained a written

representation from management. The matters included in a written representation vary for different engagements. As a minimum, management acknowledges that it is responsible for the fair presentation of the financial statements on which the auditor is expressing an opinion. The representation serves to emphasize that management, not the auditor, is responsible for the financial statements.

TIS Section 9000

AUDITORS' REPORTS

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Section 9110

Compliance Reports

.04 Auditors' Reports on Local Governments

Inquiry—A state law referring to the audit of local governments requires every auditor's report to state that the audit was conducted in accordance with generally accepted auditing standards and with the auditing standards prescribed by the state treasurer. The law also requires the auditor's report to conform with the standard report form and to contain a reference to a report of comments and recommendations.

May a CPA include such wording in his opinion if he has followed the standards prescribed by the state treasurer and he has included a report of comments and recommendations?

Reply—A CPA may state in his report that the audit has been conducted in accordance with generally accepted auditing standards and with the standards prescribed by the state treasurer if the audit was in fact conducted in conformity with these standards.

Also, it would be proper for a CPA to include in his opinion letter a reference to a report of comments and recommendations if such a report has in fact been issued.

➤→ *The next page is 9521.* ←➤

Section 9210

Accounting Changes

.01 Reasons for the Cumulative Effect of Accounting Changes

Inquiry—According to Accounting Principles Board Opinion No. 20, the cumulative effect of a change in accounting must be included in income of the current period. It seems that this would cause the income statement to give a poor picture of operations since an increase or decrease from the prior periods' income would not necessarily show that the company was doing better or worse. Why, then, should the cumulative effect of the change be shown in the current period?

Reply—The reason for this method of reporting is indicated in paragraph 18 of APB Opinion No. 20:

The Board believes that, although they conflict, both (a) the potential dilution of public confidence in financial statements resulting from restating financial statements of prior periods and (b) consistent application of accounting principles in comparative statements are important factors in reporting a change in accounting principles. The Board concludes that most changes in accounting should be recognized by including the cumulative effect, based on a retroactive computation, of changing to a new accounting principle in net income of the period of the change . . . but that a few specific changes in accounting principles should be reported by restating the financial statements of prior periods . . .

Therefore, the cumulative effect approach represents a practical solution to this conflict.

.02 Change in Accounting for Pre-operating Costs

Inquiry—A client, whose stock is not presently traded publicly, anticipates making a public offering. The offering probably would occur sometime after the end of the fiscal year.

The client presently defers pre-operating costs of new retail stores. They wish to change the method of accounting for pre-operating cost to expensing such costs as they are incurred.

May the client restate the prior year's financial statements under the provisions of paragraph 29 of Accounting Principles Board Opinion No. 20?

Reply—The special exemption provisions of paragraph 29 apply only to those cases where there is a "forthcoming public

offering" of shares of equity securities of a company. The Board concluded in such cases that the "financial statements for all prior periods presented may be restated retroactively. . . ." The exemption is available only once for changes made at the time a company's financial statements are first used for any of the purposes stated in the paragraph.

If the client makes the change in its financial statements for the current year, the provisions of APB Opinion No. 20 which require cumulative effect reporting should be applied. Paragraph 29 would be applicable at the time the client began to prepare its financial statements in connection with the public offering. At that time, the prior years presented in the registration statement would have to be restated. In this connection, normally more than one prior year's income statement is required. The client would not be precluded from making the change in the current year, but accounting for the change would be different.

.03 Change in Service Lives of Fixed Assets

Inquiry—A reevaluation of the lives of depreciable property resulted in an increase in the remaining lives of certain properties. The company would like to include the cumulative, net of tax effect of this change in income. Is this in accordance with generally accepted accounting principles?

Reply—Accounting Principles Board Opinion No. 20 is quite specific regarding the treatment of changes in estimated service lives of depreciable assets. Such a change is considered a change in an accounting estimate and should be recorded prospectively, that is, in the period of the change and future periods as appropriate. Therefore, the proposed accounting would not be in accordance with generally accepted accounting principles. If the change in service lives of depreciable property were accounted for as suggested, the independent auditors would have to issue a qualified or adverse opinion depending upon materiality of the item.

.04 Disclosure of Change in Fiscal Year

Inquiry—What disclosure, either in the financial statements or in the auditor's report, is necessary when a company changes its fiscal year?

Reply—Neither Accounting Principles Board Opinion No. 20, *Accounting Changes*, nor Statement on Auditing Standards No.

1, section 420, *Consistency of Application of Generally Accepted Accounting Principles*, specifically discuss a change in the fiscal year. The effect of making the change should be disclosed in the current period under the third standard of reporting. The auditor's opinion need not refer to the change provided the effect of the change is adequately disclosed.

.05 Change in Method of Applying Overhead

Inquiry—A client has used a percentage of direct labor in work in process inventories to determine the amount of applicable overhead. The percentage of direct labor concept became too broad and refinements were necessary to determine overhead for various types of jobs. Due to these refinements, overhead in inventory was decreased. Is this considered a change in accounting estimate or a correction of an error in previously issued financial statements?

Reply—The adjustment made for the change in overhead is not considered an error. APB Opinion No. 20, paragraph 13, discusses correction of an error in previously issued financial statements. Among the statements in paragraph 13 is the following:

A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error for purposes of applying this Opinion.

In the problem presented, the application of overhead on the basis of direct labor costs is not considered a method that is not “generally accepted.”

APB No. 20, paragraph 7, states, “A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes ‘not only accounting principles and practices but also the methods of applying them.’” It appears that a change in the method used in applying overhead is a change in a method of applying accounting principles and, therefore, should be reported in accordance with APB Opinion No. 20, paragraphs 17, 19, 20 and 21.

.08 Change in Accounting Estimate for Discounted Receivables

Inquiry—Corporation A is contingently liable for the repossession of buyer receivables upon their default for nonpayment. In the past year the volume of defaults has increased. If Cor-

poration A increases its allowance for defaults as a result of such experience, is the increase in the allowance an accounting change?

Reply—The term accounting change is defined in APB Opinion No. 20, paragraph 6, as a change in (a) an accounting principle, (b) an accounting estimate, or (c) the reporting entity. Changes in estimates are further discussed in paragraphs 10 and 11 of the Opinion and paragraphs 31 to 33 indicate how a change in estimate should be reported and disclosed.

The increase in the allowance represents a change in accounting estimate and should be reported and disclosed in accordance with APB Opinion No. 20, paragraphs 31 to 33.

.09 Changes in Reporting Entity

Inquiry—SAS No. 1, section 420, paragraphs 7 through 9, discusses the applicability of the consistency standard to a change in the reporting entity, which is a special type of change in accounting principle. Are paragraphs 7(b) and (c), which state that a change in reporting entity results when there is a change in the specific entities included in consolidated or combined financial statements, and paragraph 9, which states that a change in reporting entity does not result from the creation, cessation, purchase or disposition of a subsidiary, contradictory?

Reply—No. The creation, cessation, purchase, or disposition of a subsidiary or other business unit is a factual change in the legal structure of the entity and therefore does not require recognition in the auditor's opinion. Changes that require such recognition are those that can be arbitrarily made by management.

»»→ *The next page is 9651.* ←««

Section 9310

Errors and Irregularities

.01 Effect on Auditor's Opinion of Failure to Record Liability

Inquiry—A client collected a special assessment from the members of his club. The excise taxes on this assessment were never remitted to the federal government, and the liability was never recorded. Is it sufficient to fully disclose this liability in the footnotes and disclaim an opinion in the auditor's report, or is withdrawal from this engagement required?

Reply—When an actual liability exists, it should be recorded. Footnote disclosure is not an alternative since it does not cure the defects in the statements. If the client refuses to record and report this debt, there are two choices of action: 1) express an adverse opinion or 2) withdraw from the engagement.

A disclaimer of opinion is not considered appropriate since there is sufficient information to form an opinion that the financial statements are not fairly presented. Statement on Auditing Standards No. 2, paragraph 45 discusses the use of a disclaimer of opinion.

.02 Disclosure of Corporation's Political Contributions

Inquiry—A corporation made a political contribution to a candidate seeking local public office. Such a contribution is permissible under state law. What, if any, special disclosure requirements are necessary for such a contribution? This contribution is not a deductible item for federal income tax purposes, and it is expressly understood that a corporation cannot make a contribution to a candidate for federal office.

Reply—If the disbursement is expected to further the proper objectives of the corporation, there is no need for any special treatment. If the amount is material to net income, the expense should be appropriately disclosed. Further, if the amount is not deductible for income tax purposes and, therefore, pre-tax accounting income differs materially from the amount reported for income tax purposes, appropriate disclosure should be made in accordance with paragraph 63(c) of Accounting Principles Board Opinion No. 11.

If the disbursements appear to be for the benefit of individual

officers rather than of the corporation itself, and if it appears that the payments are material either to the salaries of those benefited or to the profits of the organization, appropriate disclosure should be made.

.03 Auditor's Request to Extend Scope of Examination

Inquiry—During the testing of internal control, vouching of transactions, and confirmation of bank accounts and loan balances, it became evident to an independent auditor engaged to audit the records of a company that the system of internal control was inadequate and that defalcations had occurred. The auditor informed the board of directors and told them that the audit could not continue without extending the scope of examination. If the Board of Directors does not authorize extending the scope of examination, should the auditor disclaim an opinion on the financial statements?

Reply—Since the auditor has information that any financial statements prepared from the company's records may not be presented fairly in accordance with generally accepted accounting principles, a disclaimer of opinion under these circumstances would not be appropriate.

The auditor's course of action depends on further actions of the Board of Directors. If the Board of Directors does not authorize the auditor to extend the scope of his examination, the auditor should withdraw from the engagement, subject to advice from legal counsel, and advise the Board of Directors in writing of the reasons for withdrawal.

➤➤➤ → *The next page is 9751.* ← ➤➤➤

Section 9320

Uncertainties

.02 Disclosure of Potential Tax Liability of Uncertain Amount

Inquiry—A corporation and its officers are under investigation by the Internal Revenue Service. It is alleged that the incomes of a number of the corporation's unconsolidated subsidiaries were allocated artificially over a period of years to avoid the tax surcharge for corporate income over \$25,000.

The revenue agent's report on the civil liability for taxes has not been issued pending resolution of criminal actions against the officers. Even though the company expects to appeal any decisions against it, the client believes that the taxes

➤→ *The next page is 9751-3.* ←➤

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

How should the potential liability be disclosed in the financial statements if the amount to be assessed is uncertain? How should the auditor report?

Reply—In view of the magnitude of the amount of possible additional taxes, penalties, and interest involved in relation to the company's net assets, the potential tax liability should be disclosed in the notes to financial statements. The auditor should express a qualified opinion because of the magnitude of the amount of possible additional taxes, penalties, and interest involved in relation to the client's net worth. Note 8 to paragraph 25 of SAS No. 2 indicates that an auditor is not precluded from disclaiming an opinion in cases involving uncertainties. Note disclosure and auditor's report might be as follows:

Note describing potential tax liability:

Note X: The Internal Revenue Service is examining tax returns filed by the corporation and its subsidiaries covering the years ending December 31, 19XX to 19XX inclusive. Informal indications are that charges based on section 482 of the Internal Revenue Code will be asserted against the corporation. Section 482 provides that if two or more organizations, trades, or businesses are owned or controlled by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions or credits between them, if he determines the action is necessary to prevent evasion of taxes or to reflect the income clearly. No revenue agent's report has as yet been issued about additional assessment for deficient taxes, and the corporation has not recorded a liability for contingent additional taxes.

Auditor's report

Scope paragraph: same as auditor's standard report.

Explanatory paragraph:

Note X to the consolidated financial statements describes that the Internal Revenue Service is examining the tax returns of the Corporation and its subsidiaries for the years 19XX to 19XX. Although no notice of additional assessments has been received, the Internal Revenue Service has indicated informally that assessments for additional taxes will be assessed against the Corporation. The amount of such assessments, which could be substantial, cannot be estimated at this time.

Opinion paragraph in part:

In our opinion, subject to the effects of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the accompanying consolidated financial statements. . . .

[Amended]

.03 Litigation of Uncertain Effect on Financial Statements

Inquiry—A company became involved in litigation shortly before its audited financial statements were to be issued. The

company is not aware of having committed the alleged acts which are the basis for the suit.

The money damages claimed in the suit are in an unstated amount, and the company's counsel is unable to determine any specific facts relating to the allegations since the pretrial hearing has not commenced and the summons was not specific as to the charges.

What comments are necessary in the auditor's report concerning the possible litigation?

Reply—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.

.07 Client Information About Litigation, Claims, and Assessments

Inquiry—SAS No. 12 requires an auditor to obtain from a client's legal counsel corroboration of information that the client furnishes about litigation, claims and assessments. Company A, a small owner-operated company, has not needed to retain legal counsel. Can the auditor of Company A express an unqualified opinion on the financial statements of Company A?

Reply—The auditor may express an unqualified opinion even though he has not obtained a letter from legal counsel of the company. The auditor should obtain written representation from Company A that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation.

»»→ *The next page is 9851.* ←««

Section 9330

Subsequent Events

.01 Failure to Remit Withholding Taxes in Subsequent Period

Inquiry—In the course of an examination of the financial statements, the auditor has discovered that in the period subsequent to the balance sheet date the company has not remitted to the appropriate agencies the taxes currently withheld from employees' wages. Assuming the amount is material, is it necessary that this matter be disclosed in the auditor's report?

Reply—Section 560.03 of Statement on Auditing Standards No. 1 states in part:

The first type [of subsequent events] consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. . . . The financial statements should be adjusted. . . .

Section 560.05 of SAS No. 1 states in part:

The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements. Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading.

Even if it is determined that the financial statements are not directly affected, it is possible that the situation indicated future serious difficulties that might require disclosures.

If the delinquent obligations are not evidence of serious financial difficulties, there usually would be no reason why obligations incurred subsequent to the balance sheet date need be reported in financial statements as of such date. In such a case, it should be expected that the delinquent payments will soon be remitted.

[Amended]

.02 Disclosure of Note Receivable Covering Previous Account of Bankrupt Company

Inquiry—Company A reports on a fiscal year ending January 31. Company A's accounts receivable include a material amount due from a bankrupt company. To avoid legal action, several individuals formed a new company. The new company and the individuals signed a note which would pay the accounts receivable of the bankrupt company over a three year period. The note was signed on March 1, subsequent to the balance sheet date. Should the note receivable, assumed to be collectible, be presented in the balance sheet at January 31?

Reply—Section 560 of Statement on Auditing Standards No. 1 deals with subsequent events. Paragraph 560.07 states, "Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements . . . because such events typically represent the culmination of conditions that existed over a relatively long period of time." Accordingly, the accounts receivable should be reported as a note receivable at January 31, with adequate disclosure of the financial arrangements made after the balance sheet date.

.03 Discovery of Potential Liability in Subsequent Period

Inquiry—In the period subsequent to the balance sheet date, the auditors discovered that an employee of the client had used a company purchase order to obtain merchandise for his personal business. This transaction resulted in a material potential liability of the client. Negotiations with the creditor ensued and the client's attorney was successful in securing a complete release from any obligation on the part of the client.

Is it necessary to disclose this matter on the client's financial statements?

Reply—According to section 560.03-.04 of Statement on Auditing Standards No. 1, the resolution of this matter appears to constitute a subsequent event which is evidence of a condition that existed at the balance sheet date, but since no transaction in fact occurred which involved the client, it is not necessary to disclose the matter in the financial statements. However, a condition which did affect the client and which did exist at the balance sheet date is the future legal costs of settling the matter. Provisions for these costs (if they are material) should be made

on the financial statements, and the reasons for incurring these costs should be disclosed.

➤→ *The next page is 10,051.* ←➤

Section 9390

Other Disclosure Requirements

.01 Disclosure of Agreement Between Principal Stockholders

Inquiry—An enterprise under audit has entered into an agreement with its two stockholders (each holding 50 percent of the outstanding stock) that upon the death of the first of the two stockholders, the surviving stockholder will have the option of either (1) having the corporation purchase the stock of the deceased stockholder at a value determined under a formula set forth in the agreement, or (2) causing the corporation to be partially liquidated by paying over to the personal representative of the deceased stockholder, a proportionate part of the assets of the corporation.

Does this type of agreement have to be shown as a commitment in the balance sheet of the corporation in order to comply with requirements of full disclosure?

Reply—The rule of informative disclosure does require that the essential facts of the agreement involving this important commitment be succinctly set forth in a footnote to the financial statements. The footnote should clarify whether one of the options must be exercised; or whether one of the options, or neither, may be exercised. Such disclosure should be on a continuing basis.

.02 Disclosure of Dependence on Sales Activity of Principal Stockholder

Inquiry—The principal stockholder of a corporation is also the corporate secretary and a member of the board of directors, but he is not otherwise involved in management and is not frequently consulted on corporate operations. This man is, however, the company's most productive salesman generating almost half the company's revenues. Is it necessary to disclose to the stockholders the importance of the principal stockholder to the corporation and the significant loss of revenue if he should leave the company?

Reply—It is generally necessary, where the major portion of the company's income is derived from a single source, that such source be disclosed. This would appear to be particularly true

where a major source of income is the result of the unique personal endeavors of a single officer or employee.

.03 Effect on Auditor's Opinion of Trustee's Management of Investment Funds

Inquiry—A municipal school building corporation (SBC) sells bonds to finance the construction of public schools and collects rents from the schools to repay the bonds and interest. The SBC operates through a trustee which is a bank responsible for investing excess funds of the SBC.

The president of the SBC is employed as a principal officer of the trustee bank and manages its insurance department. The bank sells a substantial portion of the insurance coverage to the public schools which includes the property rented to the school by the SBC. A second board member of the SBC administers the function of insuring the school properties and also furnishes one-third of the insurance coverage through his insurance agency.

The trust indenture requires the SBC to have properties appraised by an architect for insurance purposes. Appraisals are made by the state rating bureau which covers all school properties and does not segregate the property related to the SBC as required by the trust. The trust indenture also requires that an audit "covering the operations" shall be furnished.

From their examination of the SBC funds, the auditors have concluded that the trustee has not invested the maximum amount of excess funds. Excess funds are supposed to be invested in U.S. government securities but were invested in a certificate of deposit in the trustee bank. What comments should the auditors include in their report concerning these matters?

Reply—The auditors' conclusion that the trustee could have more profitably employed the funds should not affect their opinion on fair presentation of financial position or results of operations. However, it would be appropriate to express their views in a commentary report, if such a report is rendered.

As the insurance agency bills the beneficiary of the trust for insurance premiums, there is no need to disclose the relationship between the insurance agency and the trustee in a report on the trust. It is assumed that policies have been placed with insurance companies that are independent of the trustee, and that commissions are standard.

The auditors should report any failure to conform to the trust indenture. Thus, if the appraisal by the state rating bureau does not meet the terms of the indenture, the auditors should so report. However, there may be adequate information in the report by the rating bureau to furnish evidence that the insurance carried on the trust property adequately meets the terms of the indenture.

.05 Disclosure of Economic Dependency

Inquiry—Company A owes a substantial amount to its major supplier. If the supplier pressed for payment or ceased shipments, Company A could be put out of business. What type of opinion should the auditor express on the financial statements of Company A?

Reply—SAS No. 6, paragraph 5, states:

Disclosure of economic dependency may, however, be necessary for a fair presentation of financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles.

The auditor should be able to express an unqualified opinion provided the business relationship is fully disclosed and the account is *not delinquent*. If the account is delinquent and the major supplier threatens or actually ceases shipments prior to the date of the auditor's report, the auditor may conclude that a modification of his report is appropriate. See SAS No. 34, paragraph 11. [Amended]

➡ The next page is 10,151. ←

Section 9410

Audited Financial Statements

.01 Audit Requirements for Regulation A Corporation

Inquiry—A corporation, previously an over-the-counter company, went public in 1960 under Regulation A and sold \$300,000 worth of common stock at that time. No additional sales of stock have been made since then. There are currently less than 500 shareholders and total assets do not exceed \$1,000,000.

The financial statements since 1960 have always been audited, but as an economy measure, the company plans to eliminate the audits in the future.

Is there a requirement that this company must issue audited statements?

Reply—There are no statutory requirements under SEC regulations that require an audit under these circumstances. However, the company should determine if state securities regulations require audited financial statements.

.02 Going Concern Assumption for Venture with Limited Life

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

Should there be any exception in the accountant's opinion now or near the final years of operations on the assumption that after a certain fixed period it will no longer be a "going concern"?

Reply—If the purpose of the corporation and its expected life are disclosed all along in both the financial statements and related footnotes, no "going concern" qualification would be necessary.

.03 Opinion on Balance Sheet Only

Inquiry—Occasionally, a client will request from a CPA only an audited balance sheet with footnotes even though the CPA has examined and reported on all the financial statements. The usual purpose of this statement is for presentation by the client to a supplier for securing credit.

In complying with such a request, one CPA furnishes the client with the balance sheet, the notes to all the financial statements, and the following report:

We have examined the balance sheet of X company as of December 31, 19xx, and the related statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet presents fairly the financial position of X company at December 31, 19xx, in conformity with generally accepted accounting principles applied on the basis consistent with that of the preceding year.

Does such a practice satisfy the CPA's reporting obligation according to Statement on Auditing Standards No. 2?

Reply—Paragraphs 5 and 13 of SAS 2 can be interpreted to justify the expression of an opinion on a balance sheet only. In expressing such an opinion, the scope paragraph need not refer to the examination of related statements which are not being presented. The only information necessary to the readers of this report would concern the examination of the balance sheet.

The notes to the financial statements which do not pertain to the balance sheet should be omitted. However, if depreciable property is a significant portion of assets, the disclosures called for by paragraph 5 of Accounting Principles Board Opinion No. 12 should be considered necessary to fair presentation of the balance sheet. Disclosure as to pension plans, except for the amount of expense for the current year, would also be called for.

.04 Opinion on Balance Sheet with Disclaimer on Income Statement

Inquiry—A CPA firm has been engaged to perform the initial audit of a company. Since the firm did not observe the inventory taking at the beginning of the period and it is not practicable for it to satisfy itself by other means as to the beginning inventory, the firm plans to issue an opinion only on the balance sheet and disclaim an opinion on the income statement. Would this be in accordance with paragraph 13 of Statement on Auditing Standards No. 2?

Reply—Since the engagement involves a scope limitation, Statement on Auditing Standards No. 2, paragraph 13, does not

apply because that pertains to examinations that are unrestricted. SAS No. 2, paragraph 5, however, would apply and concludes, "The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances call for this treatment." SAS No. 1, section 542.05 states, "If the independent auditor has not satisfied himself by means of other auditing procedures with respect to opening inventories, he should either disclaim an opinion on the statement of income or qualify his opinion thereon . . ."

If an opinion is disclaimed on the income statement, a disclaimer on the statement of changes in financial position would also be required as illustrated in section 542.05 of SAS No. 1.
[Amended]

.05 Unqualified Opinion on Both Consolidated and Equity Basis Statements

Inquiry—A CPA firm has been requested to give an opinion on financial statements of a parent company with wholly owned subsidiaries. Consolidated financial statements, and separate statements for the parent company with investments in the subsidiaries reported on the equity method are to be issued.

Could an unqualified opinion be issued on financial statements prepared both on the consolidated and the equity methods for the same company?

Reply—Accounting Research Bulletin No. 51, paragraph 24 states:

In some cases parent-company statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent. Consolidating statements, in which one column is used for the parent company and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information.

Accounting Principles Board Opinion No. 18, paragraph 14 states in part:

The equity method is not, however, a valid substitute for consolidation and should not be used to justify exclusion of a subsidiary when consolidation is otherwise appropriate. The Board also concludes that parent companies should account for investments in the common stock of subsidiaries by the equity method in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity.

This last sentence means that the consolidated statements would represent the financial statements of the primary reporting entity, and, if they are issued to the stockholders, the parent's unconsolidated statements could even report the investment in subsidiaries at cost, but the equity method would be acceptable.

Based on the above references, an unqualified opinion on the company's financial statement presented both on a consolidated and on the equity basis in accounting for subsidiaries would not be precluded.

.06 Reference in Financial Statements to Auditor's Report

Inquiry—Audited financial statements often contain a note such as:

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

or a note sometimes reads

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

The only difference between the two notes is the inclusion of the phrase, “and accountant's opinion.” Is a reference to the opinion necessary?

Reply—Section 110.02 of Statement on Auditing Standards No. 1 discusses the distinction between responsibilities of the auditor and management and concludes, “The financial statements remain the representations of the management.” Therefore, the accountant's opinion cannot be an integral part of the financial statements, and it is inappropriate to include it by reference.

[Amended]

.08 Auditor's Restriction on Reproduction of Financial Statements

Inquiry—At the close of an audit, the auditors give the client a document which contains the client's financial statements and the “Accountants' Report.” The accountants' report, called “Our Report,” includes a description of the auditors' examination, an expression of opinion, and necessary explanatory comments regarding the financial statements. On the first page of each document leaving the auditors' office is a caveat worded as follows:

Our reports are issued with the understanding that, without our consent, they may be reproduced only in their entirety. Should it be

desired to issue or publish a condensation or a portion of this report and our name is to be used in connection therewith, our approval must first be secured.

Jones and Company
Certified Public Accountants

Since the financial statements are the representations of the client, the auditors have no right to restrict their reproduction except when they are associated with the statements. The phrase "Our Reports" gives the impression that each and every page contained within the binding are representations of the auditors but only the "Accountants' Report" belongs to the auditors.

The following alternatives are being considered:

1. Do away with the caveat altogether.
2. Reword the caveat for clarity and understandability, but continue to issue as a separate page.
3. Reword the caveat as above, but include it as a third paragraph to the "Accountants' Report."

Which of the above alternatives should the auditors adopt?

Reply—The financial statements and the notes are the client's representations although their form and content are often influenced by the auditor. Therefore, the auditors should define their policy in an engagement letter signed by the client and kept in the auditor's files. This procedure would obviate the necessity of including the caveat with each report and set of financial statements issued.

.09 Arrangement of References to Financial Statements in Auditor's Report

Inquiry—The examples of auditor's opinions in the Statements on Auditing Standards all seem to refer to the statement of financial position first, followed by the statement of results of operations, and finally the statement of changes in financial position. Is it necessary that the financial statements be presented in this order and the statements be referred to in the auditor's report in this order?

Reply—The order in which the financial statements are referred to in the independent auditor's report need not follow the order in which the statements are physically arranged. The suggested standard report such as shown in SAS No. 2, paragraph 7 can be used regardless of the order in which the financial statements are presented.

.10 Substitution of Term "Audit" for "Examination" in Auditor's Report

Inquiry—The standard auditor's report states, "We have examined. . . ." and, "Our examination was made in accordance. . . ." Is there any objection to substituting the words "audited" and "audit" for "examined" and "examination" in the auditor's report?

Reply—There is no objection to substituting "audit" for "examination" in the auditor's report. [Amended]

**.12 Basic Financial Statements Based on LIFO Inventory—
Supplemental Statements Based on FIFO Inventory**

Inquiry—Company A presents inventory in basic financial statements based on the LIFO cost method and supplemental financial statements based on the FIFO cost method. How should an auditor's report covering the supplemental statements be worded in an auditor-submitted document?

Reply—Appropriate wording based on guidelines stated in SAS No. 29, paragraph 6, for an auditor's report covering the supplemental financial statements follows:

Our examination was made to enable us to express an opinion on the basic financial statements of Company A for the years ended December 31, 19X2 and 19X1, which are presented in the preceding section of the report. As disclosed, the Company's policy is to prepare its annual financial statements on the last-in, first-out (LIFO) method. The accompanying supplemental balance sheets and supplemental statements of income were prepared for purposes of additional analysis using the first-in, first-out (FIFO) method of inventory valuation and are not a required part of the basic financial statements. Our examination did not include the adjustments made in preparing the supplemental presentations and, accordingly we express no opinion on the supplemental financial statements. The accompanying supplemental financial statements are not intended to present financial position or results of operations.

In addition, the accompanying FIFO presentation should be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. (SAS No. 29, paragraph 13)

➡ **The next page is 10,551.** ←

Section 9430

Signing and Dating Reports

.01 Use of Successor Firm Name in Signing Registration Statement

Inquiry—A CPA firm has been requested to provide an opinion on the consolidated financial statements of a client covering a five-year period. During this five-year period, the CPA firm has undergone several changes in its organization and its name:

1. Opinions for the first two years were issued by John Doe & Co.
2. In the third year, the accounting practice merged with another firm and the opinions for years three and four were signed by Doe, Roe & Co. Primary responsibility for the client was retained by the partners of John Doe & Co.
3. This partnership was later dissolved and the opinion in year five was signed by John Doe & Co., who, under the dissolution agreement, retained the working papers for this client.

Since it is impracticable to obtain the consent of each partner of the dissolved partnership, may the opinion on the five-year statements be issued by John Doe & Co.?

Reply—This situation is discussed in Statement on Auditing Standards No. 15, footnote 3. Since the partners of John Doe & Co., as it presently exists, retained primary responsibility for the publicly held company in question during the merger period, and since the firm is a successor in interest to the engagement and has retained all working papers for this client, it appears that, after consideration of these circumstances, the statements of consolidated income for the five-year period may be released solely in the name of John Doe & Co. [Amended]

.02 Reporting on Companies with Different Fiscal Years

Inquiry—A CPA has a client whose fiscal year ends on June 30. A parent company of this client now wishes to go public and must file consolidated financial statements with the SEC. The

parent company, however, observes a fiscal year ending on December 31.

The CPA has been asked by the parent to provide financial statements with an auditor's opinion for the year ending December 31, 1973. To do this, the auditor must assemble figures for the period January 1, 1973, to June 30, 1973, from the financial statements for the year ended June 30, 1973, and figures for the period July 1, 1973, to December 31, 1973, from the financial statements for the year ended June 30, 1974.

The CPA has been having difficulty in segregating the financial information into these six-month periods because of the condition of the accounting records. Furthermore, the inventories were not observed nor were the receivables confirmed at the December 31 dates.

Under these conditions, should the CPA express his opinion for the year ended June 30, 1973, and disclaim an opinion for the six months ended December 31, 1973?

Reply—In order for an auditor to express an opinion on financial statements for prior periods, it is generally not necessary to observe all audit procedures required for the most recent financial statements. The footnote to paragraph 12 of Statement on Auditing Standards No. 2 (in referring to absence of confirmation of receivables and observation of inventories) indicates that the omission of these procedures at the beginning of the year is not required to be disclosed in situations where the independent auditor has satisfied himself by other auditing procedures. However, he may wish to disclose the circumstances of the engagement and briefly describe the other procedures.

Generally, if the client's records are reasonably well kept and the auditor has satisfied himself as to year-end financial statements, review of ratios of sales to cost of sales and determination that accruals have been properly recognized at the interim date will enable an auditor to satisfy himself that the financial statements at an intervening interim date are fairly presented. On the other hand, if no perpetual inventory records are kept and if the client has not prepared inventories as of the interim date, it may not be practicable to reconstruct such inventory, and a disclaimer of opinion must be expressed on the reconstructed statements. In such circumstances, it would appear necessary that the auditor indicate in a middle paragraph that, due to the

fact that he was not engaged to make an examination of financial statements as of such date until June 30, 1974, he was not in a position to observe the amount of inventory at such date and is unable to satisfy himself thereto by the application of other auditing procedures. If this be the case, the SEC would probably be willing to accept combined income statements based on statements of the subsidiary company as of a date six months different than the parent and to accept unconsolidated balance sheets, with the balance sheet of the subsidiary being presented as of its appropriate year-end. The absence of correspondence with debtors and creditors would probably not cause similar problems.

.03 Dates of Representation Letter and Auditor's Opinion

Inquiry—On certain complex audit engagements, the letter of representation is not prepared and submitted to the client for his review and signature prior to a complete review of the audit working papers by a partner of the firm. This working paper review is sometimes completed several weeks subsequent to the completion of the audit field work and, not infrequently, develops additional items upon which the partner feels written representations should be obtained from the client.

Statement on Auditing Standards No. 1, section 560.12 reads in part, "Obtain a letter of representations dated as of the date of the auditor's report." Section 530.01 of SAS No. 1 reads in part, "Generally, the date of completion of the field work should be used as the date of the independent auditor's report." In the situation described above, when should the letter of representation and auditors' opinion be dated? If the letter of representation is dated later than the completion of field work, would the review of subsequent events have to be extended to that date?

Reply—Review of the audit working papers is a part of the auditing procedures leading to the auditors' opinion. The letter of representation focuses on areas developed as a result of the review of the audit working papers and should not be dated later than the auditors' opinion. If the letter of representation is as of a date later than the date of completion of the audit field work, the auditors' opinion should bear the same date, since obtaining a letter of representation is an auditing procedure presumed to be performed prior to the issuance of the auditor's report.

The auditor would not be obligated to extend his subsequent events review to the later date, since the items covered in the

letter of representation result from a review of the working papers which reflect the audit work performed.

➤→ *The next page is 10,751.* ←◀

Section 9510

Special Reports

.01 Determination of Sales Price Based on Auditor's Report

Inquiry—A CPA has been designated by a contract of sales to prepare a statement of “net current assets” and a statement of net income of the selling firm. Both are elements in the determination of the sales price.

A disagreement has arisen between the seller and the buyer as to the pricing of the inventory which represents the major portion of the “net current assets.” The seller relies on a formula represented as “heretofore agreed. . . .” The buyer demands a formula “based upon good accounting practice.”

The CPA believes he may have to submit two inventory values to comply with the contract provisions—one to describe the “net current assets” which will use the formula set forth in the contract, and a second using the normal pricing methods of prior years. There is a major variation between the two. The formula in the contract was not represented as being based on good accounting methods but was developed by management after the date of their latest audit.

Can the CPA express an unqualified opinion on each of the two statements if different price bases are used provided full disclosure is made?

Reply—This is a special report situation and these are special circumstances in which the auditor may have a certain reporting latitude he might not otherwise have. Since seller and buyer were both parties to the contract, the CPA was designated by the contract to prepare specified statements, and the contract apparently describes a special formula to be used in pricing inventories, the CPA would ordinarily perform strictly according to the terms of the engagement and report on one set of statements as being fairly presented or correctly presented in accordance with the specified contractual formula.

However, since the CPA is aware of the basic disagreement between seller and buyer, he might be much more helpful towards ultimately resolving the issue if he were to prepare statements on both bases.

The auditor may properly report on the two statements prepared in accordance with different inventory pricing bases, full disclosure, of course, being assumed. A more significant question, under the circumstances, is whether he has (or can obtain) consent from both parties modifying the terms of the engagement to allow preparation of the statements on a dual basis.

.03 Audit of Sales for Percentage-of-Sales Lease Agreements

Inquiry—Tenants' lease agreements with a large shopping center provide for a minimum annual rental plus a percentage rent for sales in excess of a certain dollar amount. In accordance with the leases, the shopping center has engaged the services of a CPA to verify that sales exceeding the specified minimum base are being reported. If the CPA is satisfied that the internal control of a tenant is good, may he rely on copies of sales tax returns filed with the state as sufficient evidence for his examination? Is any further verification necessary if a tenant submits a written confirmation of its annual sales from its CPA?

Reply—The degree of reliance which the auditor can place on the work of a tenant's CPA will depend upon many considerations such as those described in section 543 of Statement on Auditing Standards No. 1. Comparison of the sales figure reported to the client with the figure reported on the tenant's sales tax return would not in itself be sufficient verification, and additional procedures will be necessary.

An audit program suitable for determining the annual sales of the tenants will have to be highly flexible. Flexibility is required so as to enable the field auditors involved to adjust the audit procedures employed from store to store, as dictated by changes in types of merchandise sold, selling policies employed, sufficiency of records maintained, adequacy of internal control, etc. Accordingly, the depth of the examination will vary to some extent with almost every tenant audited.

Procedures might include examining weekly cash reports submitted by store managers and comparing these reports with general ledger entries, bank statements, and state and federal tax returns, and test checking consecutively numbered sales invoices.

Perhaps the most important documents to play a role in such an examination of the tenants' sales will be the lease agreements

which provide the very basis for such examination and which may well contain restrictions on the number and type of records and reports that each tenant will be required to make available.

.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.

.06 Middle Paragraph of Report on Cash Basis Financial Statements

Inquiry—SAS No. 14, paragraph 8, illustrates reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles. The illustration for a report on cash basis financial statements includes the following middle paragraph:

As described in Note X, the Company's policy is to prepare its financial statements on the basis of cash receipts and disbursements; consequently, certain revenue and the related assets are recognized when received rather than when earned, and certain expenses are recognized when paid rather than when the obligation is incurred. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles.

Is the suggested middle paragraph intended to be a qualification or to be informational?

Reply—The suggested middle paragraph is considered to be informational rather than a qualification of the accountant's opinion. The opinion paragraph of the illustrated report is unqualified as to presentation on the basis of accounting described in the middle paragraph.

.07 Statement of Cash Receipts and Disbursements

Inquiry—What wording should be used in the auditor's report for reporting on a statement of cash receipts and disbursements?

Reply—SAS No. 14 includes a statement of cash receipts and disbursements as a financial statement. Although a statement of cash receipts and disbursements is a summary of cash activity, it should not be confused with financial statements prepared on the cash basis of accounting, which is a comprehensive basis of accounting that, among other things, prescribes classifying results of transactions as assets, liabilities, revenue, and expenses.

The following illustrates a report on a statement of cash receipts and disbursements.

We have examined the statement of cash receipts and disbursements of ABC Association for the years ended December 31, 19X2 and 19X1. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note X, the statement of cash receipts and disbursements is a summary of the cash activity of the Association and does not present transactions that would be included in financial statements of the Association presented on the accrual basis of accounting, as contemplated by generally accepted accounting principles. Accordingly, the accompanying statement is not intended to present financial position or results of operations in conformity with generally accepted accounting principles.

In our opinion, the accompanying statement presents fairly the cash receipts and disbursements of ABC Association for the years ended December 31, 19X2 and 19X1.

.08 Statutory Basis Financial Statements Differ from GAAP

Inquiry—Financial statements filed with a state regulatory agency are prepared on a statutory basis which differs from generally accepted accounting principles. How should the accountant report on the financial statements if he knows they will be distributed to third parties other than the regulatory agency?

Reply—A practical way of handling this situation can be found in SAS No. 14, paragraph 5, footnote 4, which amended SAS No. 1, section 544.04. In applying this paragraph, the auditor's report would take the following format:

- The first paragraph would be the standard scope paragraph.
- The second paragraph would be an explanation in full of the differences including the monetary effects in the accounting principles between GAAP and the state mandated policies, or alternatively, a brief description of the differences with a reference to a footnote identifying these differences in detail.
- The third paragraph would be the qualified or adverse opinion regarding the application of GAAP.

- The fourth paragraph would be an opinion stating whether the financial statements are presented in conformity with the prescribed basis of accounting mandated by the state regulatory agency.

.09 Guidelines of State Accounting Guide Differ from GAAP

Inquiry—The guidelines stated in a State Department of Education accounting guide do not follow those stated in an AICPA Industry Audit Guide, *Audits of Colleges and Universities*. Are reports on financial statements conforming to the State accounting guide requirements considered special reports under SAS No. 14?

Reply—Yes. Reports on financial statements conforming to the State accounting guide requirements are considered special reports, under SAS No. 14. SAS No. 14, paragraph 4, states that a basis of accounting that an entity uses to comply with the requirements or financial reporting provisions of a government regulatory agency to whose jurisdiction it is subject is a comprehensive basis of accounting other than generally accepted accounting principles. SAS No. 14, paragraph 8, illustrates a special report on such financial statements for filing solely with the agency.

➤→ *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.

➤→ *The next page is 10,951.* ←➤

Section 9530

Limited Scope Engagements

.01 Auditor's Report if Inventories Not Observed—I

Inquiry—Clients sometimes impose restrictions on their auditors with regard to the observation and testing of inventory because of the costs involved, yet they still want an opinion from the auditor. What type of opinion can be issued in such circumstances when the inventory is 10 percent or more of total assets?

Reply—Paragraphs 10—13 and 46—47 of Statement on Auditing Standards No. 2 indicate that if either confirmation of receivables or observation of inventories is omitted because of a restriction imposed by the client, and such inventories or receivables are material, the auditor should indicate clearly in the scope paragraph (or in a separate paragraph) the limitations on his work and, generally, should disclaim an opinion on the financial statements taken as a whole.

The word “generally” may be interpreted to exclude those situations in which inventories or receivables are material, but are not sufficiently material to require a disclaimer of opinion. Paragraph 11 of SAS No. 2 would appear to govern in such situations. The materiality of inventory would depend on other factors than just the ratio of inventory to total assets, involving among others the ratio of inventory not examined to stockholders' equity for a statement of financial position and the ratio of inventory to income before taxes for a statement of operations. Unless circumstances are unusual, it is doubtful that inventories could be considered not material if they amount to as much as 10 percent of total assets.

It is conceivable that there might be circumstances where, although the scope of the audit omitted observation of inventories which were in excess of 10 percent of total assets, a qualified opinion on the financial statements might be appropriate.

.02 Auditor's Report if Inventories Not Observed—II

Inquiry—An auditor has been engaged by a corporation on a limited scope basis. The engagement does not include any independent verification of the inventory. The auditor will not be

present at any physical inventory taking and the pricing and clerical accuracy of the inventory will not be tested. The inventory is material in relation to the other accounts on the client's financial statements.

What type of opinion can the auditor give under these circumstances?

Reply—The disclaimer of opinion in paragraph 47 of Statement on Auditing Standards No. 2 is appropriate when the scope limitation precludes inventory observation and any other audit tests of the inventories.

The example shown in paragraph 47 is as follows:

(Scope paragraph)

. . . Except as set forth in the following paragraph, our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

(Separate paragraph)

The Company did not take a physical inventory of merchandise, stated at \$_____ in the accompanying financial statements as of December 31, 19XX, and at \$_____ as of December 31, 19XX. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19XX is no longer available. The Company's records do not permit the application of adequate alternative procedures regarding the inventories or the cost of property and equipment.

(Disclaimer paragraph)

Since the Company did not take physical inventories and we were unable to apply adequate alternative procedures regarding inventories and the cost of property and equipment, as noted in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

.06 Distinctions Between Scope Limitations

Inquiry—Paragraph 12 of Statement on Auditing Standards No. 2 states in part: "When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements."

Footnote 4 to paragraph 12 states: "Circumstances such as the timing of his work may make it impracticable or impossible for the auditor to accomplish these procedures. In such case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not

➤→ *The next page is 10,955.* ←➤

include reference to the omission of the procedures or to the use of alternative procedures.”

Based on the above excerpts, what is an appropriate auditor’s report in each of the following situations:

Auditor is not permitted to confirm receivables but is able to satisfy himself by other means?

Auditor is not permitted to observe inventories but is able to satisfy himself by other means?

Is there a distinction between a client-imposed limitation regarding receivables or inventories and other client-imposed scope limitations?

Reply—If a client refuses to permit confirmation of receivables but the auditor is able to satisfy himself by other means, the auditor may express an unqualified opinion.

If a client refuses to permit observation of inventories but the auditor is able to satisfy himself (except as to physical quantities) by other means, the auditor cannot express an unqualified opinion. The client-imposed restriction does not enable the auditor to “make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions” in accordance with section 331.12 of SAS No. 1. Footnote 4 contemplates circumstances that are not related to any client-imposed restrictions, and are not within the control of either the client or the auditor.

Paragraph 11 of SAS No. 2 states: “The auditor’s decision to qualify his opinion or disclaim an opinion because of a scope limitation depends on his assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the financial statements examined. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.” Client-imposed limitations on confirmation of receivables and observation of inventories, and scope limitations in other areas should be evaluated on the basis of paragraph 11. Since section 331 of SAS No. 1 is still in effect, the evidential matter requirements for receivables and inventories would generally cause auditors to treat

scope limitations on these items differently from other scope limitations. The final determination of how to report client-imposed scope limitations can only be made by the independent auditor involved after considering all the surrounding circumstances.

.07 Inadequate Internal Controls and Financial Records

Inquiry—How should the auditor report that he has been unable, because of inadequate internal controls and financial records, to satisfy himself that all transactions were recorded?

Reply—Section 546.15 of SAS 1, states, in part:

Inadequate financial records or limitations imposed by the client may preclude the independent auditor from forming an opinion as to the consistent application of accounting principles between the current and the prior year, as well as to the amounts of assets or liabilities at the beginning of the current year.

Paragraph 10 of SAS 2 which deals with scope limitations, states, in part:

Restrictions on the scope of his examination, whether imposed by the client or by circumstances such as the timing of his work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require him to qualify his opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

A disclaimer of opinion in this situation would be appropriate under SAS 2 if the effects of the inadequacy of internal control and the accounting records are sufficiently pervasive. Otherwise, a qualified opinion may be appropriate.

.08 Effects of Scope Limitation on Auditor's Opinion

Inquiry—Paragraphs 40, 46, and 47 of Statement on Auditing Standards No. 2 describe the form of report for an auditor in reporting on financial statements if the scope of the auditor's examination is limited. Do paragraphs 46 and 47 contradict 40?

Paragraph 46 states:

He should state that the scope of his examination was not sufficient to warrant the expression of an opinion.

Paragraph 47 states:

The scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

Paragraph 40 states:

Wording such as “In our opinion, except for the above-mentioned limitation on the scope of our examination . . .” bases the exception on the restriction itself, rather than on the possible effects on the financial statements, and therefore is unacceptable.

Reply—Paragraphs 46 and 47 do not contradict paragraph 40. The topic of paragraph 40 is the wording of a *qualified* opinion. A qualification should not be based on the restriction itself; a qualification should pertain to the possible effects on the financial statements. On the other hand, paragraphs 46 and 47 pertain to a *disclaimer of opinion* where the scope limitation itself does not permit the auditor to evaluate the possible effects on the financial statements.

.09 Letter of Audit Inquiry Not Sent to Client's Legal Counsel

Inquiry—If a client refuses to send a letter of audit inquiry to its legal counsel, can the auditor express an unqualified opinion on the client's financial statements?

Reply—SAS No. 12, paragraph 6, states:

. . . the auditor should request the client's management to send a letter of inquiry to those lawyers with whom they consulted concerning litigation, claims, and assessments.

Paragraph 7 indicates certain other procedures that might also disclose litigation, claims, and assessments. Failure to send a letter of audit inquiry to legal counsel, when otherwise indicated, is a scope limitation which would ordinarily require the auditor to express other than an unqualified opinion.

➤→ *The next page is 11,201.* ←➤

Section 9600

Compilation and Review Engagements

.01 Compiled Financial Statements Not Adjusted

Inquiry—An accountant processes client input on a computer and produces monthly statements that do not include adjustments for changes in inventories, prepayments, and accruals, and do not include notes. Adjustments are recorded annually. Can the accountant state in his report that adjustments to make the statements not misleading have not been made?

Reply—No. The specific departures from GAAP must be disclosed. Paragraphs 39 and 41 of SSARS 1 are clear that the accountant must consider whether a modified report is adequate to disclose the departures. Paragraph 40 describes the form of report when the accountant concludes that a modified report is appropriate. The departures should be disclosed in a separate paragraph, including the effects of the departures on the financial statements, if known to the accountant, or he should state that the effects have not been determined.

.02 Inquiries for a Review Engagement

Inquiry—Appendix A of SSARS No. 1 lists certain suggested inquiries for a review engagement. Is a “yes” or “no” response sought?

Reply—Appendix A states that the list is not intended to serve as a checklist, but to describe the general areas in which inquiries might be made. The inquiries in Appendix A are presented for illustrative purposes only. They do not necessarily apply to every engagement, nor are they meant to be all-inclusive. The accountant has to bear in mind that he must achieve limited assurance about the financial statements. His inquiry and analytical procedures should be designed to provide him with that assurance. A review should not be treated as a mechanical exercise to obtain “yes” or “no” answers to the illustrative inquiries. The accountant should exercise professional judgment based on all relevant circumstances in designing his inquiries and evaluating responses. While some of the inquiries can be answered “yes” or “no,” others cannot because they are asking “what are the procedures . . .”

.03 Working Trial Balance

Inquiry—An accountant prepares the general ledger from information supplied by a client. He prepares, from the general ledger, monthly comparative trial balances on analysis paper for the client's use. The trial balance is classified as assets, liabilities, equity, sales, cost of sales, and expenses. Do the reporting requirements of SSARS No. 1 apply to such a trial balance?

Reply—The accounts in a general ledger are normally organized in the order that they appear in the financial statements. Consequently, a working trial balance would normally list debits and credits in that same order and under this condition would not be subject to the reporting requirements of SSARS No. 1. However, when the accountant adds captions to classify and provides sub-totals and/or totals for each classification, the working trial balance becomes a set of financial statements. Accordingly, the accountant should adhere to the reporting requirements of SSARS No. 1. [Amended]

.04 Financial Statements Marked As Unaudited

Inquiry—Should each page of compiled or reviewed financial statements be marked unaudited?

Reply—SSARS No. 1 does not require nor prohibit marking each page of compiled or reviewed financial statements of a nonpublic entity as unaudited. It does, however, require that each page of the financial statements should include a reference such as "See Accountant's Compilation Report" or "See Accountant's Review Report," as appropriate.

SAS No. 26, paragraph 5, requires that each page of unaudited financial statements of a public entity should be clearly and conspicuously marked as unaudited.

.06 Disclosure for Compiled or Reviewed Financial Statements Prepared on a Comprehensive Basis of Accounting Other than GAAP

Inquiry—What constitutes adequate disclosure in compiled or reviewed financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles?

Reply—Whether an accountant or auditor is reporting on compiled, reviewed, or audited financial statements, he should

use the same criteria to evaluate disclosure. An Auditing Interpretation, "Adequacy of Disclosure in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles *," states in part:

In addition, when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, the same degree of informative disclosures is generally appropriate. For example, financial statements prepared on an income tax basis or a modified cash basis of accounting usually reflect depreciation, long-term debt and owners' equity. Thus, the informative disclosures for depreciation, long-term debt and owners' equity in such financial statements should be comparable to those in financial statements prepared in conformity with generally accepted accounting principles.

.07 Going Concern Problems

Inquiry—What is the reporting responsibility of the CPA who is engaged to issue a compilation or review report on financial statements under circumstances which would result in an auditor's qualified opinion or disclaimer of opinion due to uncertainties about the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities because of a substantial doubt about an entity's ability to continue in existence?

Reply—Uncertainties about an entity's ability to continue in existence should be disclosed under SSARS No. 1. If the client discloses the information, the CPA need not include a reference in his compilation or review report. However, he may decide to include a separate paragraph as an emphasis of a matter only and not as a reservation. See SSARS No. 1, paragraph 40, footnote 14.

.08 Supplementary Information

Inquiry—Are supporting schedules of balance sheet or income statement accounts considered supplementary information? If so, what are the reporting requirements in a review or compilation engagement?

Reply—SSARS No. 1, paragraph 43, pertains to reporting on supplementary information that accompanies the basic financial

* See *AICPA Professional Standards*, Volume 1, AU section 9621.34—39.

statements in a review or compilation engagement. The basic financial statements are usually considered as being the balance sheet, statement of income, statement of retained earnings or changes in stockholders' equity, and statement of changes in financial position. Descriptions of accounting policies and notes to financial statements are also considered part of the basic financial statements and are usually identified as such, for example, by a legend on the balance sheet, etc., indicating that the notes are an integral part of the financial statements. If supporting schedules of balance sheet or income statement accounts are not identified as being part of the basic financial statements, they are considered supplementary information.

.09 Application of SSARS No. 3 to Certain Companies Required to File with Regulatory Bodies

Inquiry—Some nonpublic entities, as defined in SSARS No. 2, paragraph 1 footnote 2, such as privately owned brokers or dealers in securities, may be required to include unaudited financial statements in a form prescribed by a regulatory body concerned with the sale or trading of securities, such as the National Association of Securities Dealers or the New York Stock Exchange. Does the first sentence of SSARS No. 3, paragraph 2, preclude an accountant from using the alternative form of report illustrated in SSARS No. 3 in those circumstances?

Reply—No. SSARS No. 3, paragraph 2, excludes from the definition of a prescribed form those forms “. . . concerned with the sale or trading of securities.” In that context, “securities” refers to those issued or to be issued by the entity submitting the prescribed form. Accordingly, an accountant is not precluded in the circumstances described in this question from using the alternative form of compilation report illustrated in SSARS No. 3 if the entity is not submitting the prescribed form in connection with the actual or contemplated sale or trading of its own securities.

.10 Review of Financial Statements Included in a Prescribed Form

Inquiry—SSARS No. 3, paragraph 3, states that “in the absence of a requirement or a request for a review report on the financial statements included in a prescribed form, the following form of standard compilation report may be used when the unaudited financial statements of a nonpublic entity are included

in a prescribed form that calls for departure from generally accepted accounting principles . . .” Can an accountant perform a review of financial statements included in a prescribed form that are presented on a basis other than generally accepted accounting principles?

Reply—A review can be performed on the financial statements included in a prescribed form prepared under any comprehensive basis of accounting (as defined in SAS No. 14, paragraph 4), but SSARS No. 1 reporting standards would apply, not those in SSARS No. 3. SSARS No. 3, paragraph 1, states in part:

The requirements of SSARS 1 and SSARS 2 are applicable when the unaudited financial statements of a nonpublic entity are included in a prescribed form. This statement amends SSARS 1 and SSARS 2 to provide for an alternative form of standard compilation report when the prescribed form or related instructions call for departure from generally accepted accounting principles by specifying a measurement principle not in conformity with generally accepted accounting principles or by failing to request the disclosures required by generally accepted accounting principles.

Accordingly, where the prescribed form calls for the departures referred to above, a review report expressing limited assurance under SSARS No. 1 would be appropriate provided that, as required by SSARS No. 1, paragraph 40, the review report discloses the departures from generally accepted accounting principles, including the departures called for by the prescribed form.

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Section 9900

Other Reporting Problems

.02 Furnishing Unbound Reports to Clients

Inquiry—A CPA gets numerous requests from clients for a set of unbound financial statements along with the usual bound sets. The unbound copy is usually reproduced on their copying machines for periodic distribution to suppliers and others. Should the CPA continue to provide these unbound statements?

Reply—This practice is dangerous since the CPA is assisting in the reproduction of his report without control over such reproduced copies. It would be preferable if he agreed to provide any additional copies of the report which may be required, thus controlling the assembly of the reproduced reports.

.03 Dates on Cover for Financial Statements

Inquiry—Paragraph 15 of Statement on Auditing Standards No. 26 specifies that an auditor's report disclose that prior year financial statements presented for comparative purposes are unaudited. Is it appropriate to include the dates of both the current year and prior year financial statements on the cover of the financial statements?

Reply—Both years may be included on the cover if the financial statements for the prior year are referred to as unaudited. [Amended]

.04 Use of "Accountants' Report" for a Disclaimer of Opinion

Inquiry—Can "Accountants' Report" be used as the title for a disclaimer of opinion?

Reply—The title, "Accountants' Report", can be used as the title for a disclaimer of opinion because a disclaimer of opinion is a type of report.

TIS

APPENDIXES

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Accounting Research Bulletins

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➡ The next page is 15,021. ←

Accounting Principles Board Opinions

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1		5210.07	15	48	5500.15
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	17	2250.04		53	5500.09
	17	4220.01		57	5500.12
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	30	5230.03		62	5500.05
	41	5230.07		64	5500.05
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	67	7610.15		24	4110.04
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	68	7610.15		25	4110.02
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	87	7610.09		30	2250.02
	87	7610.13		30	7610.06
	88	2220.08		31	2250.02
	88	6110.03		31	3200.06
	88	7600.01		31	7610.06
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	88	7610.15		14	1400.05
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	89	7610.09		17	2220.01
	89	7610.12		17	7300.05
	90	7610.09		17	7620.03
	91	7610.07		19	1400.09
	91	7610.08		19	2220.05
	91	7610.09		19	2220.08
	91	7610.18		19	2220.10
	92	7610.09		19	2220.11
	93	7610.01		19	2220.12
	93	7610.02		19	7600.06
	94	7610.02		19	7920.01
	99	7620.01	19		1300.01
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	9	6610.01		33	6400.09
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		3200.06		16	3200.02
		6130.07		16	3200.03
		7300.17		16	3200.04
		7600.05		16	6130.01
		9210.03	22	8	6935.01
		9210.04	23	2	5250.10
	6	9210.08		12	7920.01
	7	9210.05		23	6100.03
	10	6400.09		23	9210.06
	10	9210.08	25	8	7200.06
	11	6400.09		10	4140.01
	11	9210.08		10	4140.02
	13	9210.05		13	4140.01
	17	9210.05		14	4110.05
	18	9210.01		20	4140.04
	19	5210.01	26		3200.06
	19	9210.05	29	18	2210.11
	20	1300.08		21	6600.07
	20	5210.01	30		5100.29
	20	9210.05			5250.05
	21	5210.01		8	1200.02
	21	9210.05		10	5400.03
	22	5210.01		11	5400.03
	24	5210.01		12	5400.03
	29	9210.02		13	1200.02
	31	2250.02		13	5400.01
	31	6400.09		14	7920.01
	31	9210.08			

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	20	5400.02		26	2250.05
	20	6100.06		26	4110.04
	20	6400.09		26	5400.01
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	21	6400.09		26	6100.06
	22	5400.02			

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No.	Par.	Sec.	No.	Par.	Sec.
4	148	5100.14	4	151	6600.01
	148	5100.16		152	5100.14
	149	5100.14		152	5100.23
	150	5100.14		152	5100.27
	150	5100.23		153	3600.01
	150	5100.25		153	5100.14
	150	5100.27		153	5100.23
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	151	5100.09		159	2210.15
	151	5100.14		199	3400.02
	151	5100.23			
	151	5100.27			

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Opinion No.	Interp. No.	Sec.	Opinion No.	Interp. No.	Sec.
8	13	5230.03	16	30	7620.13
11	11	5250.03		33	6410.03
	16	5250.06		33	7600.05
12	1	2240.05		39	7600.06
15	Introduction	5500.09		39	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	2220.06
	20	7620.16		2	2220.11
	21	7620.15			
	26	7610.18	30	1	1200.02

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No.	Page	Sec.	No.	Page	Sec.
7	203	3500.06	15	23	4110.07
	257	1100.06		43-44	6100.07
15		4220.02		67-68	4230.01

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No.	Par.	Sec.
1	69(4)	3500.06

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No.	Title	Sec.
74-6	<i>Recognition of Profit on Sales of Receivables with Recourse</i>	2130.04
78-9	<i>Accounting for Investments in Real Estate Ventures</i>	1400.19 2220.05 2220.12
78-10	<i>Accounting Principles and Reporting Practices for Certain Nonprofit Organizations</i>	1300.07 7300.07 7300.17
80-2	<i>Accounting and Financial Reporting by Governmental Units</i>	6950.13
81-1	<i>Accounting for Performance of Construction-Type and Certain Production-Type Contracts</i>	6700.01

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No.	Sec.	Par.	Sec.	No.	Sec.	Par.	Sec.
1	110	.02	9410.06	1	542	.05	9410.04
	331		8340.13		543		9510.03
		.01	8320.02		544	.04	9510.08
		.02	8320.02		546	.15	9530.07
		.03	8320.02		560	.03	3100.04
		.03	8340.01			.03	9330.01
		.04	8320.02			.03	9330.03
		.04	8340.01			.04	9330.03
		.05	8320.02			.05	9330.01
		.05	8340.01			.07	9330.02
		.05	8340.13			.12	9430.03
		.06	8320.02		901	.24	8320.06
		.06	8340.01			.25	8320.06
		.07	8320.02			.26	8320.06
		.07	8340.01			.27	8320.06
		.08	8320.02			.28	8320.06
		.08	8340.01	2			2210.09
		.09	2140.02			5	1100.01
		.09	8320.01			5	9410.03
		.09	8320.02			7	1500.05
		.09	8320.05			7	9410.09
		.10	2140.02			10	8320.02
		.10	8320.01			10	9530.01
		.10	8320.05			10	9530.07
		.11	2140.02			11	8320.02
		.11	8320.01			11	9530.01
		.11	8320.05			11	9530.06
		.12	2140.02			12	8320.02
		.12	8320.01			12	8340.02
		.12	8320.05			12	9530.01
		.12	9530.06			12	9530.06
		.13	2140.02			13	1100.01
		.13	8320.05			13	8320.02
		.14	8320.05			13	9410.03
		.14	8320.06			13	9410.04
		.15	8320.05			13	9530.01
	332	.05	2220.11			15	1500.05
	420		9210.04			16	1500.05
		.06	5210.01			17	1500.05
		.07	9210.09			21	9320.05
		.08	9210.09			22	9320.05
		.09	9210.09			23	6400.08
	530	.01	9430.03			23	9320.05

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2		24	6400.08	14		6	9530.09
		24	9320.03			7	9530.09
		24	9320.05			Appen- dix A	8340.12
		25	6400.08				6120.01
		25	9320.02				9510.07
		25	9320.05				9510.09
		26	9320.05			4	1500.03
		35	9320.05			4	1500.05
		40	9530.08			4	9510.09
		45	9310.01			4	9600.10
		46	9530.01			5	9510.05
		46	9530.08			5	9510.08
		46	9530.08			7	1300.10
		46	9550.02			7	1500.04
		47	9530.01			8	1500.04
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		47	9530.08			8	9510.05
	47	9530.08		8	9510.09		
5		5	7300.17	15		2	9430.01
		6	7300.17	19			8900.03
		7	7300.17	26		5	9600.04
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6		5	9390.05	29			6100.01
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12			8340.09	32			3500.06
			8340.10	34		11	9390.05
			9320.07	43			7300.17
							8320.06

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Auditing Interpretation AU Sec.*	TIS Sec.
9332.13	6610.01
9337.06-.07	8340.12
9509.01-.06	9520.04
9621.34-.39	9600.06

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* See Volume 1, *AICPA Professional Standards*.

Audit and Accounting Guides

Name of Guide	Sec.	Name of Guide	Sec.
<i>Audits of Banks</i>	6100.03		6130.07
	6100.04		8340.01
	6100.07	<i>Audits of Investment Companies</i>	2220.07
<i>Audits of Brokers and Dealers in Securities</i>	1100.02		6910.01
	8340.05		6910.03
<i>Audits of Certain Nonprofit Organizations</i>	7300.17	<i>Audits of Personal Financial Statements</i>	7100.01
			7100.02
<i>Audits of Colleges and Universities</i>	1300.07	<i>Audits of State and Local Governmental Units</i>	1300.07
	6960.01		6950.03
	6960.02		6950.05
	6960.03		6950.07
	6960.04		6950.08
	6960.05		6950.10
	6960.06		6950.12
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	6960.09	<i>Audits of Voluntary Health and Welfare Organizations</i>	1300.07
	6960.11		6920.03
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	9510.09		6920.07
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			7300.07
			7300.09
<i>Audits of Finance Companies</i>	6130.02	<i>Construction Contractors</i>	6700.01
	6130.03	<i>Hospital Audit Guide</i>	1300.07
	6130.04		2210.16
	6130.05		6400.01
	6130.06		6400.02
			6400.03
			6400.06
			6400.09
			6400.10
			6400.11

Audit and Accounting Guides—(Cont'd)

Name of Guide	Sec.	Name of Guide	Sec.
<i>Medicare Audit Guide</i>	6400.04	<i>Savings and Loan Associations</i>	6110.03

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Review Services**

No.	Par.	Sec.
1		9600.03
		9600.04
		9600.07
		9600.10
	39	9600.01
	40	9600.01
	40	9600.07
	40	9600.10
	41	9600.01
	43	9600.08
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2		9600.10
	1	9600.09
3		9600.09
		9600.10
	1	9600.10
	2	9600.09
	3	9600.10

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SECURITIES AND EXCHANGE COMMISSION**Securities and Exchange Act Releases**

No.	Sec.
9000	1100.01

Codification of Financial Reporting Policies

Sec.	TIS Sec.	Sec.	TIS Sec.
201.02	7620.11	404.03.b. iv.	6910.03
210	4220.01	404.04.a	2220.09
210	4220.03		

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No.	Par.	Sec.
3	...	6960.11
4	...	7300.17

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2	...	5240.03
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5	...	3500.06
	...	8340.12
	18	3500.05
	19	3500.05
7	...	5240.03
	8	5240.06
12	...	6120.02
	5	1600.01
	12	2120.03
13	...	1500.05
	7	5600.02
	20	5600.01
	31	1400.18
14	...	7920.03
15	13	5100.29
	14	5100.29
	21	5100.29
16	...	1200.03
32	...	7300.17
37	4	2130.02
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	4	5250.02
43	...	6960.11
45	5	6940.01
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	17	6940.01
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9		6110.03

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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.

In September 1979, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*, an amendment of APB Opinion No. 20, *Accounting Changes*. This Statement specifies that the specialized accounting and reporting principles and practices contained in designated AICPA Statements of Position are preferable accounting principles for purposes of applying APB Opinion No. 20.

The Financial Accounting Standards Board has extracted the specialized accounting and reporting principles and practices contained in certain AICPA Statements of Position and has issued them in Statements of Financial Accounting Standards. Those Statements of Position are noted in this section.

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ACC Section 10,000

STATEMENTS OF POSITION ACCOUNTING STANDARDS DIVISION

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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.

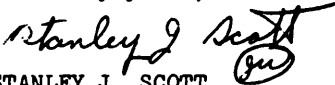
The Statement also examines the possibility that these transactions may be separated into the sale of receivables, on the one hand, and the retention of credit risks, on the other, profit and loss being allocated for each of these two elements of the overall transaction. A majority of the Executive Committee 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,

Handwritten signature of Stanley J. Scott in cursive, with a circled 'ju' at the end.

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.¹ 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

¹The 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 receivables² 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.

² 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.

* Superseded by FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, December 1982.

.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.....	500
Balance to be financed on an installment contract payable over 36 months.....	4,950
Finance charges at 12% per annum.....	968
<i>Face amount</i> of receivable (payable \$164.39 per month).....	<u>\$ 5,918</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
<i>Net receivable</i> (\$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 <i>net receivable</i>	595
Less adjustment for executory item and insurance premiums (\$300 maintenance contract fee and \$150 credit life insurance premium).....	450
Differential	<u>\$ 145</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 mainte-nance 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 com-mitment³ 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 State-ment 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 recogni-tion of profit on sales of receivables with recourse. For the pur-poses of this Statement, those two accounting methods are termed the "delayed recognition" method and the "immediate recognition" method. The delayed recognition method empha-

³ Financing commitments may be obtained directly from a lender or indi-rectly 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 repossession, 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"⁴ 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-

⁴ 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-

ceivables 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 recog-

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nized 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

* See also FASB Statement No. 45, *Accounting for Franchise Fee Revenue*, March 1981.

** See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

*** See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982, and FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.

**** See also FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, December 1981.

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.⁵ 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

⁵ 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) 575-8200

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
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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-

* From *College and University Business Administration*, third edition (Washington, D.C., 1974), by permission of the National Association of College and University Business Officers.

vestments, amounts due from other fund groups, inventories, prepaid expenses, and deferred charges. "Unbilled charges" are those which have been earned but which, because of inadequate information, incomplete projects or programs, or the timing of the billing cycle, have not been formally billed at the balance sheet date. "Undrawn appropriations" are those to which the institution is entitled, but which have not been remitted or made available to the institution by the appropriating federal, state, or local agency. "Deferred charges" are expenditures that are related to projects, programs, activities, or revenues of future fiscal periods.

Liabilities usually consist of accounts and notes payable, accrued liabilities, deposits, amounts due to other fund groups, and deferred credits. Accrued liabilities include such items as interest, wages, salaries, and taxes. Deferred credits are those revenues of unrestricted current funds that are applicable to a future period, when they become earned.

The individual assets and liabilities, but not the fund balances, of unrestricted and restricted current funds are sometimes combined for reporting purposes, but if they are combined, the borrowings between unrestricted and restricted funds should be disclosed by footnote or other appropriate means.

The fund balances may be subdivided to show allocations applicable to auxiliary enterprises, hospitals, independent operations, outstanding encumbrances, other allocations by operating management or by the governing board, budget balances brought forward from prior fiscal periods, and the unallocated balance.

Changes in the balances of unrestricted current funds include the gross amount of all unrestricted revenues and expenditures applicable to the reporting period, as determined in accordance with the accrual basis of accounting, and transfers to and from other fund groups for the period. Significant allocations of unrestricted current fund balances should be disclosed.

The fund balances of restricted current funds should be classified in the accounting system to show the various classes and sources of funds and purposes of restriction. Such restrictions often relate to the use of endowment fund income; gifts, grants, and contracts from private and governmental sources; and legislative appropriations. Further breakdowns may be provided to show amounts restricted to auxiliary enterprises, hospitals, and

independent operations, if such activities are the beneficiaries of restricted current funds.

Additions to fund balances of restricted current funds arise from the sources indicated in the preceding paragraph. Deductions from restricted fund balances result from :

1. Direct expenditures and mandatory transfers.
2. Refunds to donors and other external agencies.
3. Amounts transferred to unrestricted revenues representing indirect cost recoveries on appropriate programs.
4. Nonmandatory transfers.

Current Funds Revenues

Current funds revenues include (1) all unrestricted gifts, grants, and other resources earned during the reporting period and (2) restricted resources to the extent that such funds were expended. Current funds revenues do not include restricted current funds received but not expended or resources that are restricted by external persons or agencies to other than current funds.

Interdepartmental transactions between service departments and storerooms and other institutional departments or offices should not be reported as revenues of the service departments but rather as reductions of expenditures of such departments, since these transactions are essentially interdepartmental transfers of costs. The billed price of services and materials obtained from service departments and central stores by offices and departments of the institution should be accounted for as expenditures of those offices and departments, just as if they had been obtained from sources outside the institution. Any difference between costs and billed prices as recorded in the service department account, whether credit or debit, should be reported under the Institutional Support expenditures classification.

Certain intrainstitutional transactions, however, should be reflected in the operating statements of the institution as revenues and expenditures. Materials or services produced by an instructional department as a by-product of the instructional program and sold to other departments or to auxiliary enterprises or hospitals—for example, milk sold by the dairy department to the dining halls—should be treated as sales and services revenues

of the selling department and as expenditures of the receiving department. Sales and services of auxiliary enterprises to other departments—for example, catering by the food services department in the entertainment of institutional guests and sales by the college store to instructional departments—should be treated as sales and services revenues of the respective auxiliary enterprises and as expenditures of the unit receiving the services or materials.

Unrestricted and restricted current funds revenues should be grouped into the following major classifications by source of funds:

- Tuition and Fees
- Federal Appropriations
- State Appropriations
- Local Appropriations
- Federal Grants and Contracts
- State Grants and Contracts
- Local Grants and Contracts
- Private Gifts, Grants, and Contracts
- Endowment Income
- Sales and Services of Educational Activities
- Sales and Services of Auxiliary Enterprises
- Sales and Services of Hospitals
- Other Sources, *including expired term endowments and expired life income agreements, if not material; otherwise, separate category*
- Independent Operations

Tuition and Fees

This category should include all tuition and fees assessed against students (net of refunds) for educational purposes. Tuition and fees should be recorded as revenue even though there is no intention of collection from the student. The amounts of such remissions or waivers should be recorded as expenditures and classified as Scholarships and Fellowships or as staff benefits associated with the appropriate expenditure category to which the personnel relate.

When specific fees are assessed under binding external restrictions for other than current operating purposes—for example, debt service on educational plant or on renewals, replace-

ments, or additions to plant—they should be reported as additions to the appropriate fund group (in the above example, plant funds), since they are not legally available for current operating purposes. Fees normally are not considered as assessed under binding external restrictions unless there is an explicit representation to the individuals remitting the fees that the fee or a specific portion thereof can be used only for the specific non-operating purpose.

If some portion of total tuition or fee receipts is pledged under bond indenture agreements, the total receipts should be reported as unrestricted current funds revenues and the pledged amount treated as a mandatory transfer to plant funds.

If some portion of tuition or fees is allocated by action of the governing board, or subject to change by the governing board alone, for other than operating purposes, such as financing construction, the whole of the tuition charges or fees should be recorded as unrestricted current funds revenues and the portion allocated should be treated as a nonmandatory transfer to the appropriate fund group (in the above example, plant funds).

Revenues pledged under bond indenture agreements should not be reported as additions to plant funds, but should be reported as unrestricted current funds revenues, and funding of debt service requirements treated as mandatory transfers.

If an all-inclusive charge is made for tuition, board, room, and other services, a reasonable distribution should be made between revenues for tuition and revenues for sales and services of auxiliary enterprises.

Revenues from tuition and student fees of an academic term that encompasses two fiscal years—for example, a summer session—should be reported totally within the fiscal year in which the program is predominantly conducted.

If tuition or fees are remitted to the state as an offset to the state appropriation, the total of such tuition or fees should be deducted from the total for state appropriations and added to the total for tuition and fees.

Governmental Appropriations

This category includes (1) all unrestricted amounts received for current operations from, or made available to an institution by, legislative acts or local taxing authority and (2) restricted

amounts from those same sources to the extent expended for current operations. This category does not include governmental grants and contracts. Amounts paid directly into a state or local retirement system by the appropriating government on behalf of the college or university should be recorded as revenue of the institution. This category does not include institutional fees and other income reappropriated by the legislature to the institution.

The determination of whether a particular government appropriation should be classified as restricted or unrestricted funds is based on the ability of the governing board of the institution to effect a change in the intended use of the funds. If a change in a particular restriction can be made without having to go through the legislative process, the funds should be considered unrestricted. Funds are unrestricted even if they are distributed to the institution for purposes specified by an intermediate group, such as the governing board. In this case, if a change in the use of funds needs to be made, it can be made by the intermediate body without going through the legislative process; the funds therefore would be unrestricted. Such appropriations should be considered unrestricted funds unless the restrictions are so specific that they substantially reduce the institution's flexibility in financial operations. Appropriations in terms of major object classes or to colleges and branch institutions should be classified as unrestricted current funds.

Governmental appropriations should be classified to identify the governmental level—federal, state, or local—of the legislative body making the appropriation to the institution. The fundor level is the level of the agent that makes the decision that the moneys will be appropriated to the particular purpose for which they ultimately are expended. For example, if the federal government stipulates a specific use for some funds that merely flow through the state to the institution, the funds should be classified as federal funds. However, if the federal government distributes funds to the state for unspecified general purposes—for example, general revenue sharing—and the state then appropriates all or a portion of those funds, the funds received by the institution should be classified as state rather than federal funds.

Governmental Grants and Contracts

This category includes (1) all unrestricted amounts received or made available by grants and contracts from governmental

agencies for current operations and (2) all amounts received or made available through restricted grants and contracts to the extent expended for current operations.

Amounts equal to direct costs incurred by restricted current funds should be recorded as revenues of those funds, while amounts equal to associated indirect cost recoveries should be reported as unrestricted current funds revenues.

The government fundor level should be disclosed using the same criterion described for governmental appropriations.

Private Gifts, Grants, and Contracts

This category includes amounts from nongovernmental organizations and individuals, including funds resulting from contracting for the furnishing of goods and services of an instructional, research, or public service nature. It includes all unrestricted gifts, grants, and bequests as well as all restricted gifts, grants, and contracts from nongovernmental sources to the extent expended in the current fiscal year for current operations. Gifts, grants, and contracts from foreign governments should be treated as private gifts, grants, and contracts. Income from funds held in revocable trusts or distributable at the direction of the trustees of the trusts should be reported as a separate revenue source under this classification. This category excludes revenues derived from contracts and other activities, such as utility services, that are not related directly to instruction, research, or public service.

Amounts equal to the direct costs incurred by restricted current funds should be reported as revenues of those funds, while amounts equal to the associated indirect cost recoveries should be recorded as unrestricted current funds revenues.

Endowment Income

This category includes:

1. Unrestricted income from endowment and similar funds.
2. Restricted income from endowment and similar funds to the extent expended for current operations.
3. Income from funds held by others under irrevocable trusts, which should be identified separately under this revenue heading.

The unrestricted income from investments of endowment and

similar funds credited to unrestricted current funds revenues should be the total ordinary income earned (or yield), except for income that must be added back to the principal in accordance with the terms of the agreement of donation. If endowment fund investments include real estate, the income should be reported on a net basis after allowing for all costs of operating and managing the properties.

Income from investments of endowment and similar funds does not include capital gains and losses, since such gains and losses are accounted for in the Endowment and Similar Funds group as additions to and deductions from fund balances. If any portion of the gains of endowment or quasi-endowment funds is utilized for current operating purposes, the portion so utilized should be reported as a transfer rather than as revenue (see Chapter 5:3).

When investments of endowment and similar funds are pooled, the amounts reported as revenues of unrestricted current funds and as additions to restricted current funds should be substantially equal to the amounts earned during the fiscal period and attributable to the various funds.

Many institutions have established endowment income stabilization reserves to spread or allocate current investment income. Two methods have been followed in establishing such reserves.

Under one method, a portion of the total revenue from the investment pool is not allocated to the participating funds, but is set aside in a stabilization reserve; the balance of the investment pool revenue is distributed to the participating funds. This method is not in accordance with generally accepted accounting principles for the following reasons:

1. The balance in the stabilization reserve may represent undistributed income attributable to both restricted and unrestricted current funds. Thus the balance in the reserve cannot be reported accurately in the financial statements.
2. To the extent any of the undistributed income earned during the fiscal year is attributable to unrestricted current funds, an understatement of revenues of unrestricted current funds will occur.
3. Questions might arise as to the authority of the governing board to withhold amounts of income attributable to, but not distributed to, restricted current funds.

Institutions carrying balances in endowment income stabilization reserves created under this method should dispose of them as appropriate.

The second method, which conforms to generally accepted accounting principles, would distribute *all* income from the pools to the participating funds. The amount applicable to unrestricted current funds would be reported as endowment income. Any amounts set aside for a stabilization reserve should be shown as an allocation of the unrestricted current funds balance and appropriately reflected in the balance sheet as a subdivision of that balance. Amounts applicable to restricted current funds should be reported as an addition to those fund balances. The amounts expended from such balances should be shown as revenues of endowment income in the restricted current funds. Amounts unexpended would remain as balances to be carried forward to the next period.

Sales and Services of Educational Activities

This category includes (1) revenues that are related incidentally to the conduct of instruction, research, and public service and (2) revenues of activities that exist to provide an instructional and laboratory experience for students and that incidentally create goods and services that may be sold to students, faculty, staff, and the general public. The type of service rendered takes precedence over the form of agreement by which these services are rendered. Examples of revenues of educational activities are film rentals, sales of scientific and literary publications, testing services, and sales of products and services of dairy creameries, food technology divisions, poultry farms, and health clinics (apart from student health services) that are not part of a hospital. Revenues generated by hospitals (including health clinics that are a part thereof) should be classified as sales and services of hospitals.

If sales and services to students, faculty, or staff, rather than training or instruction, is the purpose of an activity, the revenue should be classified as sales and services of auxiliary enterprises or hospitals.

Sales and Services of Auxiliary Enterprises

This category includes all revenues generated through operations by auxiliary enterprises. An auxiliary enterprise is an en-

tity that exists to furnish goods or services to students, faculty, or staff, and that charges a fee directly related to, although not necessarily equal to, the cost of the goods or services. The general public incidentally may be served by some auxiliary enterprises.

Auxiliary enterprises usually include residence halls, food services, intercollegiate athletics (if essentially self-supporting), college unions, college stores, and such services as barber shops, beauty parlors, and movie theaters. Even though they may serve students and faculty, hospitals are classified separately because of their size and relative financial importance.

This category is limited to revenues derived directly from the operation of the auxiliary enterprises themselves. Revenues from gifts, grants, or endowment income restricted for auxiliary enterprises should be reported under their respective source categories.

Sales and Services of Hospitals

This category includes revenues (net of discounts, allowances, and provision for doubtful accounts) generated by hospitals from daily patient, special, and other services. Revenues of health clinics that are part of a hospital should be included in this category. Not included are revenues for research and other specific-purpose gifts, grants, or endowment income restricted to the hospital. Such funds should be included in the appropriate revenue sources described above.

Other Sources

This category should include all sources of current funds revenue not included in other classifications. Examples are interest income and gains and losses on investments in current funds, miscellaneous rentals and sales, expired term endowments, and terminated annuity or life income agreements, if not material.

Note: It is appropriate to subtotal all revenues described above; the subtotal excludes revenues of independent operations.

Transfers from Other Funds

Unrestricted amounts transferred from other fund groups back to the Current Funds group are not revenues of the current

funds. An example is the return of quasi-endowment funds from the endowment and similar funds to unrestricted current funds. Such amounts should be identified separately and included in Nonmandatory Transfers (see expenditure categories).

Independent Operations

This category includes all revenues of those operations which are independent of, or unrelated to, but which may enhance the primary missions of the institution—instruction, research, and public service. Included are revenues associated with major federally funded research laboratories and other operations not considered an integral part of the institution's educational, auxiliary enterprise, or hospital activities. This category does not include the net profit (or loss) from operations owned and managed as investments of the institution's endowment funds.

Additions to Fund Balances

The term "additions" is in contrast to revenues and transfers. Additions are amounts received or made available to the restricted current funds during the reporting period as distinguished from the amounts of restricted funds expended during the fiscal period, which are reported as restricted fund revenues.

Current Funds Expenditures and Transfers

Current funds expenditures represent the costs incurred for goods and services used in the conduct of the institution's operations. They include the acquisition cost of capital assets, such as equipment and library books, to the extent current funds are budgeted for and used by operating departments for such purposes. If the amount of ending inventories or the cost of services benefiting subsequent fiscal periods is material (in terms of effect on financial statements), both inventories and deferred charges should be recorded as assets and previously recorded expenditures appropriately decreased. In a subsequent fiscal period these inventories and deferred charges as consumed should be included as expenditures of that period. Significant inventories of materials are usually present in central stores.

A capital asset is defined as any physical resource that benefits a program for more than one year. Capital expenditures therefore include funds expended for land, improvements to land,

buildings, improvements and additions to buildings, equipment, and library books. Most institutional accounting systems provide for recording at least a portion of capital expenditures in the current fund expenditures accounts of the various operating units. Whether an expenditure is to be considered a capital expenditure is generally a matter for institutional determination, or in the case of some public institutions, it is prescribed by state regulation.

The general criteria for defining a capital asset are the relative significance of the amount expended and the useful life of the asset acquired, or in the case of repairs and alterations, the extent to which the useful life is extended. For expenditure reporting purposes, any item costing more than a specific amount, as determined by the institution or appropriate governmental unit, and having an expected useful life of more than one year generally should be classified as a capital expenditure.¹

Interdepartmental transactions ordinarily should be accounted for as an increase in current fund expenditures of the department receiving the materials, services, or capital assets and as a decrease in current fund expenditures of the transferring department. Thus, total institutional expenditures are not inflated by the transactions. Examples are sales and services of service departments and central stores and transfers of material and equipment from one department to another. Any differences between the revenue from sales and services and the operating costs of service departments or central stores, whether debit or credit, are treated as Institutional Support expenditures. On the other hand, sales and services of an auxiliary enterprise to another department or auxiliary enterprise, or sales of materials produced by an instructional department to another department or auxiliary enterprise, would be reported as an expenditure of the department or auxiliary enterprise receiving the materials or services and as revenue of the department or auxiliary enterprise selling the materials or services.

Expenditures differ from transfers. Expenditures are the

¹ The Cost Accounting Standards Board (CASB) has stipulated \$500 and a useful life of more than two years as the threshold at which items must be considered capital assets, and Federal Management Circular 73-8 (formerly OMB Circular A-21) defines equipment as items having an acquisition cost of \$200 or more and an expected service life of one year or more. Different limits which are reasonable and consistently applied are acceptable.

recognition of the expending of resources of the Current Funds group toward the objectives of each of the respective funds of that group. Transfers are amounts moved between fund groups to be used for the objectives of the recipient fund group. There are two types of transfers, mandatory and nonmandatory, which are fully described later in this chapter.

Expenditures and transfers may be classified in a variety of ways to serve a variety of purposes. Some of the factors bearing on the desired classification are :

1. The context in which appropriations, gifts, grants, and other sources of revenue are made to the institution.
2. The mode best suited for preparing and executing the budget.
3. The form that best serves the needs for financial reporting.
4. The presentation that will improve the quality of comparative studies among institutions.

Thus, expenditures and transfers may be classified in terms of programs, functions, organizational units, projects, and object classes.

Classifications by *program* often cut across organizational, functional, and even fund group lines and are useful in the planning processes. The *functional* classification pattern—educational and general, auxiliary enterprises, hospitals, independent operations, and their subcategories—provides the greatest comparability of data among institutions. The classification by *organizational units* provides data corresponding to channels of intra-institutional administrative responsibilities. Classification by *projects* serves to provide data corresponding to the pattern in which gifts, grants, and contracts are utilized by the institution. Classification by *object class*—that is, according to materials or capital assets purchased or services received, such as personal services, staff benefits, printing and stationery, travel, communications, food, fuel, utilities, 1 pairs, 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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* From *College and University Business Administration*, third edition (Washington, D.C., 1974), by permission of the National Association of College and University Business Officers.

Sample Educational Institution

Balance

June 30,

with comparative figures

Assets

Current Funds

	Current Year	Prior Year
Unrestricted		
Cash	\$ 210,000	\$ 110,000
Investments	450,000	360,000
Accounts receivable, less allowance of \$18,000 both years.....	228,000	175,000
Inventories, at lower of cost (first-in, first-out basis) or market.....	90,000	80,000
Prepaid expenses and deferred charges.....	28,000	20,000
Total unrestricted	<u>1,006,000</u>	<u>745,000</u>
Restricted		
Cash	145,000	101,000
Investments	175,000	165,000
Accounts receivable, less allowance of \$8,000 both years.....	68,000	160,000
Unbilled charges	72,000	—
Total restricted	<u>460,000</u>	<u>426,000</u>
Total current funds.....	<u>1,466,000</u>	<u>1,171,000</u>

Loan Funds

Cash	30,000	20,000
Investments	100,000	100,000
Loans to students, faculty, and staff, less allowance of \$10,000 current year and \$9,000 prior year.....	550,000	382,000
Due from unrestricted funds.....	3,000	—
Total loan funds..	<u>683,000</u>	<u>502,000</u>

Endowment and Similar Funds

Cash	100,000	101,000
Investments	13,900,000	11,800,000
Total endowment and similar funds....	<u>14,000,000</u>	<u>11,901,000</u>

Exhibit 1

Sheet

19_____

at June 30, 19_____

Liabilities and Fund Balances**Current Funds**

	Current Year	Prior Year
Unrestricted		
Accounts payable	\$ 125,000	\$ 100,000
Accrued liabilities	20,000	15,000
Students' deposits	30,000	35,000
Due to other funds.....	158,000	120,000
Deferred credits	30,000	20,000
Fund balance	<u>643,000</u>	<u>455,000</u>
Total unrestricted	<u>1,006,000</u>	<u>745,000</u>
 Restricted		
Accounts payable	14,000	5,000
Fund balances	<u>446,000</u>	<u>421,000</u>
 Total restricted	<u>460,000</u>	<u>426,000</u>
Total current funds.....	<u><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	<u>150,000</u>	<u>100,000</u>
Total loan funds.....	<u>683,000</u>	<u>502,000</u>

Endowment and Similar Funds

Fund balances		
Endowment	7,800,000	6,740,000
Term endowment	3,840,000	3,420,000
Quasi-endowment—unrestricted	1,000,000	800,000
Quasi-endowment—restricted	<u>1,360,000</u>	<u>941,000</u>
Total endowment and similar funds ...	<u><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	235,000	200,000
Total renewals and replacements..	<u>260,000</u>	<u>380,000</u>
Retirement of indebtedness		
Fund balances		
Restricted	185,000	125,000
Unrestricted	115,000	168,000
Total retirement of indebtedness..	<u>300,000</u>	<u>293,000</u>
Investment in plant		
Notes payable	790,000	810,000
Bonds payable	2,200,000	2,400,000
Mortgages payable	400,000	200,000
Net investment in plant	38,210,000	36,540,000
Total investment in plant	<u>41,600,000</u>	<u>39,950,000</u>
Total plant funds.....	<u>43,870,000</u>	<u>42,743,000</u>

Agency Funds

Deposits held in custody for others.....	110,000	90,000
Total agency funds.....	<u>110,000</u>	<u>90,000</u>

Policies and Notes to Financial Statements

Sample Educational Institution

Statement of Changes in

Year Ended June 30,

	<u>Current Funds</u>	
	<u>Unrestricted</u>	<u>Restricted</u>
Revenues and other additions		
Unrestricted current fund revenues.....	\$7,540,000	
Expired term endowment—restricted		
State appropriations—restricted		
Federal grants and contracts—restricted.....		500,000
Private gifts, grants, and contracts—restricted		370,000
Investment income—restricted		224,000
Realized gains on investments—unrestricted.		
Realized gains on investments—restricted.....		
Interest on loans receivable.....		
U.S. government advances.....		
Expended for plant facilities (including \$100,000 charged to current funds expenditures).....		
Retirement of indebtedness		
Accrued interest on sale of bonds.....		
Matured annuity and life income restricted to endowment		
Total revenues and other additions.....	<u>7,540,000</u>	<u>1,094,000</u>
Expenditures and other deductions		
Educational and general expenditures.....	4,400,000	1,014,000
Auxiliary enterprises expenditures	1,830,000	
Indirect costs recovered		35,000
Refunded to grantors.....		20,000
Loan cancellations and write-offs.....		
Administrative and collection costs		
Adjustment of actuarial liability for annuities payable.....		
Expended for plant facilities (including noncapitalized expenditures of \$50,000).....		
Retirement of indebtedness.....		
Interest on indebtedness		
Disposal of plant facilities		
Expired term endowments (\$40,000 unrestricted, \$50,000 restricted to plant)		
Matured annuity and life income funds restricted to endowment....		
Total expenditures and other deductions.....	<u>6,230,000</u>	<u>1,069,000</u>

Exhibit 2

Fund Balances

19____

Loan Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Plant Funds			
			Unexpended	Renewals and Replacements	Retirement of Indebtedness	Investment in Plant
			50,000			
			50,000			
100,000	1,500,000	800,000	115,000		65,000	15,000
12,000	10,000		5,000	5,000	5,000	
	109,000					
4,000	50,000		10,000	5,000	5,000	
7,000						
18,000						
						1,550,000
						220,000
					3,000	
	10,000					
<u>141,000</u>	<u>1,679,000</u>	<u>800,000</u>	<u>230,000</u>	<u>10,000</u>	<u>78,000</u>	<u>1,785,000</u>
10,000						
1,000						
1,000					1,000	
		75,000				
			1,200,000	300,000		
					220,000	
					190,000	
						115,000
	90,000					
		10,000				
<u>12,000</u>	<u>90,000</u>	<u>85,000</u>	<u>1,200,000</u>	<u>300,000</u>	<u>411,000</u>	<u>115,000</u>

Exhibit 2—Continued

Transfers among funds—additions/(deductions)	Current Funds	
	Unrestricted	Restricted
Mandatory:		
Principal and interest.....	(340,000)	
Renewals and replacements.....	(170,000)	
Loan fund matching grant.....	(2,000)	
Unrestricted gifts allocated	(650,000)	
Portion of unrestricted quasi-endowment funds investment gains appropriated.....	40,000	
Total transfers	(1,122,000)	
Net increase/(decrease) for the year	188,000	25,000
Fund balance at beginning of year.....	455,000	421,000
Fund balance at end of year.....	643,000	446,000

See accompanying Summary of Significant Accounting

<u>Loan Funds</u>	<u>Endowment and Similar Funds</u>	<u>Annuity and Life Income Funds</u>	<u>Plant Funds</u>			
			<u>Unex- pended</u>	<u>Renewals and Replaces- ments</u>	<u>Retire- ment of Indebted- ness</u>	<u>Investment in Plant</u>
					340,000	
				170,000		
2,000						
50,000	550,000		50,000			
	(40,000)					
<u>52,000</u>	<u>510,000</u>		<u>50,000</u>	<u>170,000</u>	<u>340,000</u>	
181,000	2,099,000	715,000	(920,000)	(120,000)	7,000	1,670,000
<u>502,000</u>	<u>11,901,000</u>	<u>2,505,000</u>	<u>2,120,000</u>	<u>380,000</u>	<u>293,000</u>	<u>36,540,000</u>
<u>683,000</u>	<u>14,000,000</u>	<u>3,220,000</u>	<u>1,200,000</u>	<u>260,000</u>	<u>300,000</u>	<u>38,210,000</u>

Policies and Notes to Financial Statements

Sample Educational Institution

Statement of Current Funds Revenues,

Year Ended June

Revenues

Tuition and fees	
Federal appropriations	
State appropriations	
Local appropriations	
Federal grants and contracts.....	
State grants and contracts	
Local grants and contracts.....	
Private gifts, grants, and contracts.....	
Endowment income	
Sales and services of educational departments.....	
Sales and services of auxiliary enterprises.....	
Expired term endowment.....	
Other sources (if any).....	
Total current revenues.....	

Expenditures and mandatory transfers

Educational and general	
Instruction	
Research	
Public service	
Academic support	
Student services	
Institutional support	
Operation and maintenance of plant	
Scholarships and fellowships.....	
Educational and general expenditures.....	
Mandatory transfers for:	
Principal and interest.....	
Renewals and replacements.....	
Loan fund matching grant.....	
Total educational and general.....	

Exhibit 3

Expenditures, and Other Changes

30, 19_____

Unrestricted	Current Year Restricted	Total	Prior Year Total
\$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	
7,540,000	1,014,000	8,554,000	8,180,000
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
4,400,000	1,014,000	5,414,000	5,370,000
90,000		90,000	50,000
100,000		100,000	80,000
2,000		2,000	
4,592,000	1,014,000	5,606,000	5,500,000

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
	2,045,000	1,740,000
	2,045,000	1,740,000

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	(1,000)	12.70
Unrealized net gains for year ...			2,001,000	
Realized net gains for year ...			159,000	
Total net gains for year ...			\$2,160,000	2.30

The average annual earnings per unit, exclusive of net gains, were \$.56 for the year.

2. Physical plant and equipment are stated at cost at date of acquisition or fair value at date of donation in the case of gifts, except land acquired prior to 1940, which is valued at appraisal value in 1940 at \$300,000. Depreciation on physical plant and equipment is not recorded.

3. Long-term debt includes: bonds payable due in annual installments varying from \$45,000 to \$55,000 with interest at $5\frac{7}{8}\%$, the final installment being due in 19... , collateralized by trust indenture covering land, buildings, and equipment known as Smith dormitory carried in the accounts at \$2,500,000, and pledged net revenue from the operations of said dormitory; and mortgages payable due in varying amounts to 19... with interest at 6%, collateralized by property carried in the accounts at \$800,000 and pledged revenue of the Student Union amounting to approximately \$65,000 per year.

4. The Institution has certain contributory pension plans for academic and nonacademic personnel. Total pension expense for the year was \$350,000, which includes amortization of prior service cost over a period of 20 years. The Institution's policy is to fund pension costs accrued, including periodic funding of prior years' accruals not previously funded. The actuarially computed value of vested benefits as of June 30, 19... exceeded net assets of the pension fund by approximately \$300,000.

5. Contracts have been let for the construction of additional classroom buildings in the amount of \$3,000,000. Construction and equipment are estimated to aggregate \$5,000,000, which will be financed by available resources and an issue of bonds payable over a period of 40 years amounting to \$4,000,000.

6. All interfund borrowings have been made from unrestricted funds. The amounts due to plant funds from current unrestricted funds are payable within one year without interest. The amount due to loan funds from current unrestricted funds is payable currently.

7. Pledges totaling \$260,000, restricted to plant fund uses, are due to be collected over the next three fiscal years in the amounts of \$120,000, \$80,000, and \$60,000, respectively. It is not practicable to estimate the net realizable value of such pledges.

CHART OF ACCOUNTS*

[Chapter 5: 6]

A SYSTEMATIC CLASSIFICATION of accounts is an essential part of an accounting system. The accounts should be developed to be compatible with the organizational structure of the institution, and their form and content should be arranged in agreement with the financial reports to be presented.

The arrangement should be formalized in a chart of accounts, and for ease of identification and reference, each account should be assigned an appropriate code number or symbol. Classification should be according to the funds and fund groups of the institution, as described in the preceding chapters of Part 5. Within each fund group, the accounts should be listed according to assets, liabilities, and fund balance accounts.

The illustrative chart of accounts for a college or university presented below shows those accounts usually found in the general ledger or carried in subsidiary ledgers with appropriate control accounts in the general ledger. This chart is presented as a guide for institutions in developing their own detailed charts of accounts and to help them set up their accounts in conformity with the principles of accounting and reporting presented in the preceding chapters of Part 5. The system of accounts may be expanded, contracted, or modified to meet the needs of the individual institution and to conform to its organizational structure, but in any case it should incorporate the basic elements common to all educational institutions.

In designing or revising a chart of accounts, the code numbers or symbols assigned to the accounts should progress in a logical order. Because each fund and fund group is carried in the accounting records as a separately balanced group, the accounts in any given group should be assigned a code number that, perhaps by a prefix, identifies that fund group—for example, all accounts related to current funds should be identifiable as such; all accounts for plant funds should be identifiable as such. Similarly, within the fund groups, consistent code numbers should identify subgroups, assets, liabilities, and fund balances. For revenue accounts, code numbers or symbols can be used to identify sources.

* From *College and University Business Administration*, third edition (Washington, D.C., 1974), by permission of the National Association of College and University Business Officers.

For expenditure accounts, code numbers or symbols can be used to identify functions, organizational units, projects, programs, and objects of expenditures. The individual fund identity should be an integral part of the fund balance, revenue, and expenditure account codes.

In developing a chart of accounts, it is important to exercise economy in the use of digits and characters for code numbers, to plan a logical arrangement for the chart, and to make ample provision for future expansion of account numbers.

GENERAL LEDGER ACCOUNTS

Current Funds—Unrestricted

Asset Accounts

Cash

Petty Cash

Investments

Accounts Receivable—*detailed as needed, for example:*

Students

Hospital Patients

Governmental

Unbilled Charges

Notes Receivable—*detailed as needed*

Allowance for Doubtful Accounts and Notes—*credit balance account associated with each type of receivable*

Inventories—*detailed as needed, for example:*

College Store

Dining Halls

Central Stores

Plant Operation and Maintenance Supply Store

Prepaid Items and Deferred Charges—*detailed as needed*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Notes Payable

Accounts Payable and Accrued Expenses—*detailed as needed*

Deferred Credits

Deposits

Due to Other Fund Groups

Fund Balances—Allocated—*detailed as needed, for example:*

Auxiliary Enterprises

Reserve for Encumbrances

Reserve for Computer Use Survey

Reserve for Faculty Self-Improvement Program

Fund Balance—Unallocated

Operating Accounts. The following control accounts in the general ledger for actual revenues, expenditures, and other changes are supported in detail by Current Funds Revenues and Current Funds Expenditures

and Other Changes accounts in subsidiary ledgers. If desired, several control accounts may be provided in lieu of single control accounts:

Revenues Control—*credit account*

Expenditures and Other Changes Control—*debit account*

When budgetary accounts are carried in the general ledger, the following control accounts would appear in the chart of accounts. They are supported in detail by Current Funds Revenues and Current Funds Expenditures and Other Changes accounts in subsidiary ledgers:

Estimated Revenues or Unrealized Revenues

Expenditures and Other Changes Allocations or Budget Allocations for Expenditures and Other Changes

Unallocated Budget Balance or Unassigned Budget Balance

Current Funds—Restricted

These accounts are to be used if the assets and liabilities of such funds are separated from those of Unrestricted Current Funds.

Asset Accounts

Cash

Investments

Accounts Receivable—*detailed as needed, for example:*

Governmental

Other

Unbilled Charges

Allowance for Doubtful Accounts—*credit balance account*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Due to Other Fund Groups

Fund Balances—Allocated—*detailed as needed, for example:*

Reserve for Encumbrances

Auxiliary Enterprises

Fund Balances—Unallocated

Both of the fund balance accounts may be control accounts supported by separate subsidiary ledger accounts for each restricted current fund and for each type of fund balance. Additional control accounts may be provided as required or desired.

Operating Accounts. Expenditures of restricted current funds may be recorded in the operating accounts of unrestricted current funds, in which case transfers of restricted current funds to current funds revenues accounts would be made to finance such expenditures. When this is not done, operating accounts for each current restricted fund must provide for proper classification of expenditures by object, as well as providing for appropriate categorization of sources of additions, deductions other than expenditures, and transfers to and from other funds.

Loan Funds**Asset Accounts**

- Cash
- Investments
- Notes Receivable from Students, Faculty, and Staff
 - Allowance for Doubtful Loans—*credit balance account*

Liability and Fund Balance Accounts

- Accounts Payable to Collection Agencies
- Due to Other Fund Groups
- Refunds Payable on Refundable Government Grants
- Fund Balances—*This may be a control account supported by separate subsidiary ledger accounts for each fund. Separate accounts should be carried to identify the sources of funds available for loans, such as donor- and government-restricted loan funds, including funds provided by mandatory transfers required for matching purposes, unrestricted funds designated as loan funds, and funds returnable to the donor under certain conditions. Accounts to identify allocations of fund balances should be provided. Accounts may be maintained to identify resources available for loans to students separately from those for faculty and staff.*

Endowment and Similar Funds**Asset Accounts**

- Cash
- Accounts Receivable
- Notes Receivable
 - Allowance for Doubtful Accounts and Notes—*credit balance account*
- Prepaid Items
- Investments—*detailed as needed, for example:*
 - Bonds
 - Allowance for Unamortized Bond Premiums
 - Allowance for Unamortized Bond Discounts
 - Preferred Stocks
 - Common Stocks
 - Mortgage Notes
 - Real Estate
 - Allowance for Depreciation—*credit balance account*
- Due from Other Fund Groups

Liability and Fund Balance Accounts

- The fund balance accounts should be classified as to Endowment, Term Endowment, and Quasi-Endowment Funds, even though the investments of the funds may be merged in one or more investment pools.*
- Payables—*detailed as needed, for example:*
 - Mortgages Payable
 - Notes Payable
 - Accounts Payable
 - Collateral Due on Securities Loaned
 - Due to Other Fund Groups

Balances of Endowment Funds

Balances of Term Endowment Funds

Balances of Quasi-Endowment Funds—Unrestricted

Balances of Quasi-Endowment Funds—Restricted

In order to differentiate between the balances of funds for which the income is unrestricted and those for which the income is restricted, the following accounts may be employed:

Balances of Endowment Funds—Unrestricted

Balances of Endowment Funds—Restricted—*detailed as needed, for example:*

Professorships

Instructional Departments

Scholarships

Library

Loan Funds

Note. The balances of term endowment funds also may be identified in this manner.

Undistributed Gains and Losses on Investment Transactions—*Separate accounts should be established for each investment pool.*

Undistributed Share Adjustments—*Separate accounts should be established for each investment pool.*

Annuity and Life Income Funds

If the funds in this section are pooled for investment purposes, accounts for the assets may be classified as shown below for each investment pool. If any funds are separately invested, accounts should be set up for the investment of such funds.

Asset Accounts

Cash

Accounts Receivable

Notes Receivable

Allowance for Doubtful Accounts and Notes—*credit balance account*

Investments—*detailed as needed, for example:*

Bonds

Allowance for Unamortized Bond Premiums

Allowance for Unamortized Bond Discounts

Preferred Stocks

Common Stocks

Mortgage Notes

Real Estate

Allowance for Depreciation—*credit balance account*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Annuity Payments Currently Due

Annuities Payable

Life Income Payments Currently Due

Due to Other Funds for Advances on Annuity Payments

Due to Other Funds for Advances to Income Beneficiaries

Undistributed Income—Annuity Funds

Undistributed Income—Life Income Funds

Balances of Annuity Funds

Balances of Life Income Funds

These may be control accounts supported by subsidiary ledger accounts for each fund. Within the two categories the accounts may be listed alphabetically by name, or they may be classified in any other manner at the discretion of the institution.

Undistributed Gains and Losses on Investment Transactions—*Separate accounts should be established for each investment pool.*

Undistributed Share Adjustments—*Separate accounts should be established for each investment pool.*

Income, Expenditure, and Transfer Accounts

Income from Investments—*credit account, detailed by each agreement*Expenditures and Transfers—*debit account, detailed by each agreement***Plant Funds—Unexpended****Asset Accounts**

Cash

Investments

Receivables—*detailed as needed*Allowance for Doubtful Accounts—*credit balance account*

Due from Other Fund Groups

Construction in Progress—*alternatively can be shown in Investment in Plant subgroup of Plant Funds***Liability and Fund Balance Accounts**

Accounts Payable

Notes Payable

Bonds Payable

Mortgages Payable

Due to Other Fund Groups

Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Funds for Renewals and Replacements

These accounts should be used if the assets of such funds are separated from the assets of other subgroups of Plant Funds.

Asset Accounts

Cash

Accounts Receivable

Allowance for Doubtful Accounts—*credit balance account*

Investments

Deposits with Trustees

Due from Other Fund Groups

Liability and Fund Balance Accounts

- Accounts Payable
- Due to Other Fund Groups
- Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Funds for Retirement of Indebtedness

These accounts should be used if the assets of such funds are separated from the assets of other subgroups of Plant Funds.

Asset Accounts

- Cash
- Accounts and Notes Receivable
 - Allowance for Doubtful Accounts—*credit balance account*
- Investments
- Deposits with Trustees
- Due from Other Fund Groups

Liability and Fund Balance Accounts

- Accounts Payable
- Due to Other Fund Groups
- Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Investment in Plant

Asset Accounts

- Land
- Buildings
 - Allowance for Depreciation—*credit balance account*
- Improvements Other than Buildings
 - Allowance for Depreciation—*credit balance account*
- Equipment
 - Allowance for Depreciation—*credit balance account*
- Library Books
- Art Museums and Collections
- Construction in Progress—*alternatively can be shown in the Unexpended Plant Funds subgroup of Plant Funds*

Liability and Fund Balance Accounts

- Accounts Payable
- Notes Payable
- Bonds Payable
- Mortgages Payable
- Leaseholds Payable
- Due to Other Fund Groups
- Net Investment in Plant —*detailed as needed*

Agency Funds**Asset Accounts**

Cash

Accounts Receivable

Notes Receivable

Allowance for Doubtful Accounts and Notes—*credit balance account*

Investments

Due from Other Fund Groups

Liability Accounts

Accounts Payable

Due to Other Fund Groups

Deposit Liabilities—*Accounts for each agency fund should be carried either in the general ledger or in subsidiary ledgers.***CURRENT FUNDS REVENUES ACCOUNTS
(Separate Restricted and Unrestricted Accounts)****Tuition and Fees**—*detailed as needed***Federal Appropriations****State Appropriations****Local Appropriations****Federal Grants and Contracts****State Grants and Contracts****Local Grants and Contracts****Private Gifts, Grants, and Contracts**—*detailed as needed***Endowment Income**—*detailed as needed, for example:*

Income from Funds Held by Others Under Irrevocable Trusts

Sales and Services of Educational Activities—*detailed as needed, for example:*

Film Rentals

Testing Services

Home Economics Cafeteria

Demonstration Schools

Dairy Creameries

Food Technology Divisions

Sales and Services of Auxiliary Enterprises—*detailed as needed, for example:*

Residence Halls
Faculty Housing
Food Services
College Union

Additional revenue accounts may be established for sources of sales, types of products and services, and cash and interdepartmental sales.

Sales and Services of Hospitals—*detailed as needed, for example:*

Daily Patient Services
Nursing Services
Other Professional Services
Health Clinics *if an integral part of the hospital*

Other Sources—*detailed as needed*

Independent Operations—*detailed as needed by organizational units*

CURRENT FUNDS EXPENDITURES AND TRANSFERS ACCOUNTS

Current funds expenditures accounts should bear identifying codes and symbols that will identify functions, such as Instruction, Institutional Support, and Scholarships and Fellowships; identify organizational units, such as Department of Physics, Controller's Office, and Registrar's Office; and identify the object of expenditures, such as Personnel Compensation, Supplies and Expenses, and Capital Expenditures. If desired, interdepartmental purchases, as contrasted with purchases from external sources, also may be identified by code or symbol. The object coding and symbols should be designed to provide for common usage of the objects throughout the entire chart of accounts, although, of course, there will be individual object codings that will be used only for particular functional categories.

Educational and General

Instruction

Accounts by divisions, schools, colleges, and departments of instruction following the administrative organization of the institution. The four functional subcategories are:

General academic instruction
Occupational and vocational instruction
Special session instruction
Community education

Research

Accounts by individual projects, classified by organizational units. The two functional subcategories are:

- Institutes and research centers
- Individual or project research

Public Service

Accounts by activities, classified by type of activity, such as:

- Community Service
- Conferences and Institutes
- Cooperative Extension Service
- Public Lectures
- Radio
- Television

Academic Support

Accounts by activities, classified by type of activity, such as:

- Academic Administration and Personnel Development
- Audiovisual Services
- Computing Support (*excluding administrative data processing*), unless distributed to using activities
- Course and Curriculum Development
- Demonstration Schools
- Libraries
- Museums and Galleries

Student Services

Accounts by activities, classified by type of activity, such as:

- Admissions Office
- Counseling and Career Guidance
- Cultural Events
- Dean of Students
- Financial Aid Administration
- Health and Infirmary Services *if not an integral part of a hospital nor operated as an essentially self-supporting operation*
- Intramural Athletics
- Intercollegiate Athletics *if operated as an integral part of department of physical education and not essentially self-supporting*
- Registrar
- Student Organizations
- Remedial Instruction

Institutional Support—*detailed as needed, for example:*

- Governing Board
- Chief Executive Office
- Chief Academic Office
- Chief Business Office
- Investment Office
- Legal Counsel
- Administrative Data Processing

Alumni Office
Auditing, internal and external
Safety
Security
Catalogues and Bulletins
Commencements
Convocations
Development Office
Employee Personnel and Records
Fund Raising
General Insurance *other than Property Insurance*
Interest on Current Funds Loans
Legal Fees
Memberships
Printing
Provisions for Doubtful Accounts and Notes
Publications
Public Relations
Purchasing
Service Departments

There should be interim accounts for all organizational units classified in this category; these accounts should be closed out at the end of each fiscal year.

Space Management

Telephone and Telegraph *unless charged to departmental budgets*
Transportation *including motor pool, unless operated as a service department*

Operation and Maintenance of Plant

Accounts for all organizational units and functions, such as:

Administration
Custodial Services
Maintenance of Buildings
Maintenance of Grounds
Utilities
Trucking Services
Fire Protection
Property Insurance

Scholarships and Fellowships

Accounts as needed and desired for scholarships, fellowships, grants-in-aid, trainee stipends, prizes, and awards.

Tuition and Fee Remissions *unless properly classified as staff benefit expenditures*

Accounts may be set up for instructional divisions and departments, such as:

School of Medicine
Department of Physics

Mandatory Transfers, Educational and General—*detailed to show subcategories, such as:*

Provision for Debt Service on Educational Plant
Loan Fund Matching Grants

Nonmandatory Transfers, Educational and General (*to and from*)
—*detailed to show significant subcategories, such as:*

Loan Funds
Quasi-Endowment Funds
Appreciation on Securities of Endowment and Similar Funds
Plant Funds
Renewals and Replacements of Plant Assets
Additions to Plant Assets
Voluntary Payments on Debt Principal

Auxiliary Enterprises, Hospitals, and Independent Operations

Auxiliary Enterprises

Accounts as needed and desired for such enterprises as included in the Current Funds Revenues accounts.

Provision should be made for identification of mandatory and non-mandatory transfers—to and from—by significant subcategories.

Hospitals

Accounts as needed and desired. Provision should be made for identification of mandatory and nonmandatory transfers—to and from—by significant subcategories.

Independent Operations

Accounts as needed and desired for organizational units.

Provision should be made for identification of mandatory and non-mandatory transfers—to and from—by significant subcategories.

CLASSIFICATION OF EXPENDITURES BY OBJECT

The object classification of expenditures identifies that which is received in return for the expenditures. Object classification has importance as a tool for internal management, but should be considered complementary to the classification of expenditures by function and organizational unit and should not replace these classifications in the various schedules of current funds expenditures. The value of object classification will depend on the usefulness of the information it provides to management. The classifications may be omitted from published financial reports or they may be used to any degree considered desirable by the institution. The use of object classifications and the related identifying codes

and symbols should not be carried to an extreme; the number of categories should be limited to those that will be of significant value to management.

Three major object classifications are found in most colleges and universities: Personnel Compensation, Supplies and Expenses, and Capital Expenditures. Breakdowns of objects within these major categories may be necessary or desirable in some situations.

Personnel Compensation

This classification includes salaries, wages, and staff benefits. In the various salary and wage expense accounts, it may be desirable to distinguish between groups of faculty and other staff members, such as full-time and part-time personnel; student and nonstudent workers; and professional, secretarial, clerical, skilled, and nonskilled employees. Appropriate code numbers and symbols within this category will aid in identifying, collecting, and summarizing information.

Supplies and Expenses

Because of their general significance to nearly all organizational units within an institution, it may be beneficial to identify significant categories of these expenditures, such as supplies, telephones, travel, and contractual services.

Capital Expenditures

The following object categories within this classification (which includes both additions to and renewals and replacements of capital assets) may prove helpful in the accounting and reporting systems of educational institutions: scientific equipment, laboratory apparatus, office machines and equipment, library books, furniture and furnishings, motor vehicles, machinery and tools, building remodeling, minor construction, and livestock.

»→ *The next page is 17,151.* ←«

Section 10,030

Statement of Position 74-11
Financial Accounting and
Reporting by Face-Amount
Certificate Companies

**[Proposal to Financial Accounting Standards Board to Amend
AICPA Industry Audit Guide on Audits of Investment Companies with
Respect to Face-Amount Certificate Companies]**

AICPA**American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 10, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Proposal to Amend
AICPA Industry Audit Guide on
Audits of Investment Companies
With Respect to
Face-Amount Certificate Companies

Dear Mr. Armstrong:

The accompanying Statement of Position, prepared by the Accounting Standards Task Force on Investment Companies, proposes amendments to the AICPA Industry Audit Guide on Audits of Investment Companies which would exclude face-amount certificate companies from the general definition of investment companies set forth in the Guide. Accordingly, these companies (there are four in active operation at the present time) would not be required to follow the accounting provisions of the Guide.

While issuance of this Statement of Position will be helpful to independent auditors, we urge that FASB advise the accounting profession at an early date as to whether it believes the proposed amendments are appropriate and should be regarded as having the same authoritative support as the Audit Guide itself.

Members of the Task Force will be glad to meet with you or your representatives to discuss this proposal. The Task Force would also appreciate being advised as to the Board's proposed action on its recommendations.

Sincerely yours,

ACCOUNTING STANDARDS TASK FORCE ON INVESTMENT COMPANIES

James H. Muller, Chairman
Charles Adams
Philip L. Cohen
S. Leland Dill
Robert J. Gummer

Edwin N. Hanlon
William T. Kennedy
David A. O'Keefe
Frederick M. Werblow
John Woodcock, Jr.

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NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Task Force believes would be in the public interest.

**FINANCIAL ACCOUNTING AND REPORTING BY
FACE-AMOUNT CERTIFICATE COMPANIES****BACKGROUND INFORMATION**

.01 The AICPA Industry Audit Guide sets forth the following general definition of the investment company industry:

"The business of an investment company consists of selling its capital shares to the public, investing the proceeds—for the most part in securities—in a manner seeking to achieve its announced investment objectives, and distributing to its shareholders the net income from, and the net gains realized on sales of, its investments. Generally, an investment company can be said to be a pooling of funds by shareholders to avail themselves of professional investment management."¹

¹ AICPA, *Audits of Investment Companies*, (New York: 1973), p. 1.

.02 The Guide then includes face-amount certificate companies as investment companies to which the Guide is applicable by the following:

“Within the umbrella of the above general definition fall many forms of investment companies, including management investment companies, *face-amount certificate companies* (emphasis supplied), unit investment trusts, collective trust funds, investment partnerships, and ‘offshore funds’.”²

.03 In its Glossary, the Guide defines a face-amount certificate as “A security representing an obligation of the issuer to pay a stated amount at a fixed date in the future, the consideration for which is either payment of periodic installments of a stated amount or a single lump payment.” A face-amount certificate company is “An investment company engaged in the business of issuing face-amount certificates of the installment type.”³

.04 The task force has reconsidered the appropriateness of including face-amount certificate companies in the definition of “investment companies” included in the Guide.

RECOMMENDATION

.05 The Task Force believes that face-amount certificate companies do not fall within the general definition of investment companies set forth in the Guide and, therefore, such companies should not be required to follow the accounting provisions of the Guide.

.06 Specifically, the Task Force believes that *Audits of Investment Companies* should be amended as follows:

- (a) The phrase “face-amount certificate companies,” should be deleted from the first sentence of the second paragraph on page 1 of the Guide.
- (b) The definition of a face-amount certificate company on page 141 of the Guide should be changed to read, “A company (not an “investment company” as defined elsewhere herein, but subject to the provisions of the Investment Company Act of 1940) engaged in the business of issuing face-amount certificates of the installment type.”

² *Ibid.*

³ *Ibid.*, p. 141.

REASONS FOR RECOMMENDATIONS

.07 The Guide's definition of an investment company quoted earlier in this Statement of Position is not met by face-amount certificate companies for the following reasons:

- (a) The business of a face-amount certificate company does not consist of "selling its capital shares to the public." Such companies (there are only four in active operation at the present time) are in the business of selling certificates which are fixed obligations and liabilities of the company.
- (b) A face-amount certificate company does not distribute to its certificate holders "the net income from, and the net gains realized on sales of, its investments."
- (c) A face-amount certificate company does not pool funds obtained from its shareholders. It pools the funds obtained from its certificate holders with the hope that the investments made will both satisfy the company's obligations to those certificate holders and result in a profit for shareholder(s).

.08 Because of these essential differences between face-amount certificate companies and investment companies, which were not recognized in the Guide, it is not appropriate to define face-amount certificate companies as a type of investment company for the purposes of the Guide and, therefore, such companies should not be required to follow the accounting provisions of the Guide.

➤→ *The next page is 17,451* ←➤

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.

* See also FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, September, 1982

Statements of Position

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 (ml)

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-

* See also FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, September, 1982.

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-subsiary 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

Stanley J. Scott, Chairman	Irving B. Kroll
Hector R. Anton	Raymond C. Lauver
Philip B. Chenok	James J. Quinn
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ACCOUNTING STANDARDS TASK FORCE ON MORTGAGE BANK PORTFOLIOS

December 30, 1974

Alvin Zuckerkorn, Chairman	Joseph Hearne
Thomas Asson	Robert Hermance
	Robert McMullen

»»→ *The next page is 17,901.* ←««

Section 10,060**Statement of Position 75-2
Accounting Practices of
Real Estate Investment
Trusts****[Recommendation to Financial Accounting Standards Board]****AICPA****American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

June 27, 1975

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices of Real Estate Investment Trusts. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate. The scope of the Statement is restricted to REITs, although it is acknowledged that the conclusions therein may also be appropriate for companies which are not REITs.

The Statement takes the position that the allowance for losses on loans and foreclosed properties should now be determined based on an evaluation of the recoverability of individual loans and properties and, in this evaluation, the principle of providing for all losses when they become evident should now require the inclusion of all holding costs, including interest, in determining such losses.

The individual evaluation of the loans and foreclosed properties should be made, according to the Statement, as of the close of all annual and interim stockholder reporting periods. This may well result in a need to increase or decrease the allowance for losses with a corresponding charge or credit to income. However, in the case of foreclosed property which the REIT elects to hold as a long-term investment, the Statement concludes that the net realizable value of such property at the date of foreclosure becomes its new basis, and subsequent increases in market values of such properties should generally not be recorded until the time of a later exchange transaction which confirms the amount of any increase.

The Statement also takes the position that recognition of interest revenue should be discontinued when it is not reasonable to expect that the revenue will be received and enumerates conditions which should now be regarded as establishing a presumption that the recording of interest should be discontinued.

Statements of Position

Finally, the Statement concludes that commitment fees should be amortized over the combined commitment and loan period, and provides guidance with respect to appropriate accounting by a REIT for operating support from its adviser.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,


STANLEY J. SCOTT
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

**ACCOUNTING PRACTICES OF
REAL ESTATE INVESTMENTS TRUSTS *****INTRODUCTION**

.01 Real estate investment trusts (REITs) have in recent years assumed an increasingly important role in the real estate industry. REITs are business trusts and are generally publicly-held. They employ equity capital, coupled with substantial amounts of debt financing, in making real estate loans and investments.

.02 A REIT, if it so elects, will not be required to pay Federal corporate income taxes (other than that on "tax preference" items) if, among other things, at least 90% of its taxable income, as defined, is distributed to its shareholders. This Statement, however, is not restricted to those REITs which have elected such tax treatment.

.03 The accounting problems discussed in this Statement of Position may also be encountered by other companies which are not REITs but which are engaged in the business of making loans on or investing in real estate. The conclusions in this

* See also section 10,170.

Statement of Position may, therefore, also be appropriate for those companies. However, the accounting practices of companies which are not REITs are beyond the scope of this Statement of Position.

.04 REITs have engaged in a variety of lending and investing activities, some of which are listed below.

Construction loans are generally short-term first mortgage loans to finance the construction of residential, commercial or industrial properties. Interest revenue on such loans is usually accrued and added to the loan balance, which is paid from the proceeds of permanent financing.

Development loans are short-term first mortgage loans to finance site development costs. They are usually paid from proceeds of a construction loan.

Land acquisition loans are first mortgage loans to finance the acquisition (not the development) of sites.

Long and intermediate term loans are generally conventional mortgage loans to finance completed properties.

Purchase leasebacks consist of the simultaneous purchase and leaseback to the seller of real estate properties.

Equity investments in real estate are direct ownership interests, under a variety of forms, in improved or unimproved real estate.

Junior mortgage loans are real estate loans subject to the lien of a prior mortgage.

Wrap-around loans are junior mortgage loans to provide an owner with funds without disturbing a prior first mortgage loan which, for various reasons, is not liquidated.

Gap loans are junior mortgage loans to finance a temporary spread between amounts advanced and amounts committed under a prior first mortgage loan.

Warehousing loans are short-term loans secured by the pledge of mortgage loans.

.05 In connection with real estate loans, a REIT may issue a commitment, which is an agreement to make a mortgage loan in the future at specified terms.

.06 A REIT's financial success is often dependent upon external factors, among which are the operations of its contractor-borrowers, the availability to those contractors of long-term mortgage funds when projects are completed, and the general condition of the real estate industry. The success of the REIT

is also dependent upon its ability to obtain financing *at rates less than that earned on its portfolio of investments.*

.07 Considerable attention has recently been given to the accounting practices of REITs, particularly those which relate to loans which are in default or may become in default. This Statement of Position addresses certain of those practices.

LOSSES FROM LOANS

.08 REITs are subject to the usual risks associated with loans, investments in real estate, and commitments to make loans. These risks include adverse changes in economic conditions, both national and local, changes in interest rates, availability of mortgage financing, supply and demand for properties in specific areas, and governmental actions such as zoning and environmental regulations, among many others.

.09 REIT industry practices vary considerably with respect to providing for losses resulting from their lending activities. The Division believes it is desirable to narrow the range of acceptable practices.

.10 When it appears that an original borrower will be unable to make the payments required by the terms of his loan agreement, a REIT has several alternatives. It can place the loan in a "work-out" status with the expectation that its financial position with respect to the loan will be improved through careful monitoring of the borrower's activities coupled with continued advances on the loan when necessary. It may renegotiate the terms of the loan with the original borrower with the hope that more liberal lending terms will insure at least partial recovery of principal and interest. It may search for another borrower to assume management of the real estate collateralizing the loan and to assume responsibility for the loan. It may initiate foreclosure proceedings or accept a deed in lieu of foreclosure to obtain title to the property collateralizing the loan.

.11 Depending on the state in which property is located and depending on the complexity of a borrower's financial arrangements, foreclosure proceedings may be time consuming. However, once foreclosure has been effected, the REIT has two alternative courses of action: to dispose of the property or to hold it for investment. In either case, the REIT may have to invest additional funds to bring the property to salable and/or income-producing condition.

.12 Whether a loan appears to be "good" or "troubled" and whether a REIT elects to foreclose on a troubled loan or chooses one of the other alternatives mentioned above, it is in all cases not so much the credit standing of the borrower which is studied in determining recoverability as it is the real estate which serves as collateral for the loan. The reason for this is that in few cases would a REIT's borrower be able (or willing) to repay a loan from other sources.

.13 Accordingly, the Division believes that the essential problem to be addressed relates to the valuation of real estate and that the conclusions reached in this Statement of Position are equally applicable to the determination of allowances for losses on loans (both "good" and "troubled") and on foreclosed

properties.¹ In addition, the initial valuation method should be the same for foreclosed properties held for resale and those held as an investment.² The Division's objective is to identify a method of providing for losses which will result in an allowance which is, in the aggregate, reasonable in the context of the financial statements taken as a whole. [As amended by Statement of Position No. 78-2.] (See section 10,170.)

.14 Three methods for determining a provision for loan losses for REITs have been predominantly followed in practice, as discussed below.

Systematic Provision—Some REITs establish a provision for losses in what is considered to be a systematic manner. The most common methods are to base the provision on a fixed percentage of loans or net income.

Individual Evaluation—Some REITs establish a provision for losses based on an evaluation of the individual loans or foreclosed properties to estimate the amount of any loss that may reasonably be expected.

Combination Method—Other REITs record a provision for losses equivalent to an amount determined by evaluation of at least certain major or problem loans and foreclosed properties, increased by a provision which generally represents a percentage of loans or of net income.

.15 The Division believes that the allowance for losses should now be determined based on an evaluation of the recoverability of individual loans and properties which gives consideration to the facts and circumstances in existence at the time of the evaluation and to reasonable probabilistic estimates of future economic conditions and other relevant information. The allowance should not be determined on the basis of percentages of loan balances, income or other similar bases.

¹ Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, prescribes the accounting required for assets received or transferred in troubled debt restructurings consummated after December 31, 1977, with earlier application encouraged. The recommendations in this section, "Losses from Loans," concerning loans and properties have been amended in certain respects to conform with FASB Statement No. 15. (See "Assets Affected by Troubled Debt Restructurings.") The recommendations in this section continue to apply to foreclosed properties acquired before the effective date of FASB Statement No. 15 and for which earlier application of that Statement is not elected.

² See, however, paragraph .27 for additional comments with respect to foreclosed property held as a long-term investment.

.16 Because of the many factors which can affect recoverability, the *estimated* loss on an individual loan or property may not be the same as the ultimate loss, if any, *actually* sustained on each. While the individual evaluation method, like all estimation methods, inherently lacks precision, it best achieves, in the Division's view, the ultimate objective of determining an allowance for losses which is, in the aggregate, reasonable in the context of the financial statements taken as a whole.

.17 Evaluation of the recoverability of individual loans and properties entails a comparison of the carrying amount (including recorded accrued interest, but not previously determined allowances for losses) of each such loan or property with its estimated net realizable value. With respect to a REIT, estimated net realizable value means the estimated selling price a property will bring if exposed for sale in the open market, allowing a reasonable time to find a purchaser, reduced by (a) the estimated cost to complete and improve such property to the condition used in determining the estimated selling price, (b) the costs to dispose of the property, and (c) the estimated costs to hold the property to the estimated point of sale, including interest, property taxes, legal fees and other cash requirements of the project. However, some REITs, because of liquidity problems or for other reasons, may not be able or willing to hold foreclosed property and, therefore, must estimate the selling price on an immediate liquidation basis.

.18 Some do not believe that estimated interest holding costs should be considered in the determination of estimated net realizable value. They point out that, with limited exceptions, interest has been traditionally considered a period cost. They believe that this recommended practice is a part of the broader problem of recognition of the cost of capital and argue that it is inappropriate to reach a conclusion with respect to REITs before that broader problem is resolved. In the real estate industry, interest is clearly an economic cost of holding property and, therefore, the Division does not find these arguments persuasive. In the case of a REIT, the Division believes that the principle of providing for all losses when they become evident should now require the inclusion of all holding costs, including interest, in determining such losses.

.19 Some would support the Division's position if it were restricted to investments which are expected to be held in excess

of a stipulated minimum period of time related to the operating cycle of a REIT. The Division does not agree with this view.

.20 The Division believes that the guidelines described below should be followed with respect to estimating interest holding costs in the determination of estimated net realizable value.

.21 The interest rate should be estimated based on the average cost of all capital (debt and equity). This rate should be calculated by dividing debt interest costs by the aggregate of equity capital and debt. Debt interest costs should normally be based on the interest rate used for accruing interest expense at the date of the balance sheet. However, information available prior to the issuance of the financial statements (e. g., renegotiation of the REIT's debt) should be considered in determining whether that rate is appropriate. The objective is to arrive at a rate which would, *in the light of existing agreements*, correspond with the rate to be used for accruing interest expense during the estimated holding period of the property.

.22 Examples of the application of these guidelines, using present value techniques, are included in the appendices to this Statement of Position.

.23 The effective rate of interest used in the calculations should be disclosed in the notes to financial statements.

.24 A minority of four members of the Accounting Standards Executive Committee dissent from the procedure recommended above for the determination of net realizable value. In their view, treating interest cost in the manner specified results in valuing an asset differently depending upon (1) the credit standing of the entity and the resultant interest rate required to be paid on debt and (2) the entity's capital structure, i. e., the mix of debt and equity. The minority believes that net realizable value should be determined by looking only to the asset and the market considerations related to it, which should result in the same measurement for any entity whose use of the asset is the same, i. e., the net realizable value of the asset should not be affected by which entity owns it or how that entity is capitalized. In this regard, they see no reason to distinguish real estate assets from other assets.

.25 As previously noted, the individual evaluation method entails a determination of the net realizable value of the property. Some factors to be considered in the valuation of property are as follows:

- (1) The current status or nature of the property and its condition.
- (2) The current actual use of the property and the future uses of the property as related to general economic conditions and the population growth in the area.
- (3) The overall suitability of the property for its current or intended use.
- (4) Various restrictions including zoning and other possibilities.
- (5) Comparable prices of other properties in the area.

.26 The individual evaluation of loans and foreclosed properties should be made as of the close of all annual and interim stockholder reporting periods.

.27 The periodic evaluation of loans and foreclosed properties may well result in a need to increase or decrease the allowance for losses with a corresponding charge or credit to income. An exception to the foregoing should be made in the case of foreclosed property which the REIT elects to hold not for sale but as a long-term investment. The net realizable value of such property at the date of foreclosure becomes its new basis, in accordance with generally accepted accounting principles for long-term investments. Subsequent increases in market values of such properties should generally not be recorded until the time of a later exchange transaction which confirms the amount of any increase. (See APB Statement No. 4, Paragraph 183.)

.28 The Division believes that the appropriate presentation of loans, foreclosed property held for resale, and the allowance for losses in the balance sheet would be as follows:

Loans, earning	\$xxx	
Loans, nonearning	xxx	
Foreclosed properties held for resale.....	xxx	
	—	
	\$xxx	
Allowance for losses	\$xxx	\$xxx
	—	—

.29 There are numerous conditions which may indicate that a loss will be incurred on a loan. Some of these conditions are discussed in paragraphs .30—.38.

ASSETS AFFECTED BY TROUBLED DEBT RESTRUCTURINGS

.29A Properties acquired by an REIT in a troubled debt restructuring and accounted for in accordance with FASB Statement 15 should be recorded as if they had been acquired for cash at their fair value, which becomes their cost basis for accounting purposes. Periodically thereafter the properties should be evaluated and allowances for losses should be provided in accordance with the recommendations on "Losses from Loans."

.29B When it is probable that an REIT will enter into a troubled debt restructuring with one of its *debtors* that will result in a loss determined in accordance with the provisions of FASB Statement 15 in excess of the allowance, if any, provided in accordance with the recommendation on "Losses from Loans" in this Statement, a provision should be made for the excess loss. Thereafter, until the restructuring occurs, the loan receivable should be periodically evaluated in a similar manner, and the allowance for losses should be adjusted at each evaluation date for changes in the estimated loss. In no event should the loan, less the allowance for loss, exceed its estimated net realizable value.

.29C When it is probable that an REIT will enter into a troubled debt restructuring with one of its *creditors* that will result in a loss on transfer of an identified asset (determined in accordance with FASB Statement 15) in excess of the allowance, if any, provided in accordance with the recommendations on "Losses from Loans" in this Statement, a provision should be made for the excess loss on the identified asset to be transferred net of the related gain, if reasonably determinable, on reduction of the payable that will result from the asset transfer. The Accounting Standards Division believes that it is appropriate to include the effect of the gain in providing for the additional loss, because it is the asset transfer that produces both the loss on transfer and the gain on restructuring. The provision for the excess net loss should be reported as an expense in determining income before extraordinary items. After providing for the excess net loss, the allowance for losses will be an amount that reduces the carrying amount of the identified asset to be transferred to its estimated fair value, net of the related estimated gain (not in excess of the loss on the identified asset to be transferred) on the reduction of the payable that will result from the asset transfer. In no event, however, should the identified asset

to be transferred, less the allowance for losses, exceed its estimated net realizable value. The notes to the REIT's financial statements should disclose the effect on the allowance for losses of the estimated gain on the payable to be restructured as described in the preceding sentence. Also, the note should state that, when realized, such gain will be reported as an extraordinary item with a corresponding charge to income before the extraordinary item.

[As amended by Statement of Position 78-2.] (See section 10,170.)

DISCONTINUANCE OF INTEREST REVENUE RECOGNITION

.30 While some REITs argue that recognition of interest revenue should never be discontinued, it seems clear that there is no sound basis in theory or practice for such a position, since it is well established in accounting that if sufficient doubt or uncertainty exists as to realization, recognition may not be appropriate.

.31 In practice, the recognition of interest revenue has usually been discontinued at one of the following points:

- (1) When the amount of any final loss can be determined with a high degree of precision (e. g., upon final settlement).
- (2) Upon the occurrence of certain specified events (e. g., interest or principal is a certain number of days past due, cost overruns are at a certain percentage, foreclosure proceedings are being initiated, etc.)
- (3) When judgment—often involving an evaluation of total loan recoverability, including estimated recoverability from foreclosure and sale—indicates that any additional interest would not be realized.

.32 Postponing the discontinuance of interest recognition until a loss can be determined with a high degree of precision is in conflict with general practice and theory.

.33 A common practice is to discontinue the recognition of interest upon the occurrence of certain specified events. Its attractiveness lies in the ability to determine objectively if the criteria have been met and, as a result, it is presumed there would be a greater uniformity in the reported results of REITs following this practice.

.34 Opponents of this practice acknowledge that specific criteria may be useful in identifying potential problem loans but believe that arbitrary rules cannot be a substitute for management's judgment. It is argued that even though a loan may meet an established criterion for the discontinuance of interest recognition, it is still possible that the loan and the interest will ultimately be collected; thus, to discontinue recognition in such a situation is as incorrect as recognizing interest when it is clear it will not be collected.

.35 The Division believes that the recognition of interest revenue should be discontinued when it is not reasonable to expect that the revenue will be received. The Division also believes that certain conditions, such as any one of the following, should now be regarded as establishing a presumption (which may be overcome if other facts clearly refute the presumption) that the recording of interest should be discontinued.

- (1) Payments of principal or interest are past due.
- (2) The borrower is in default under the terms of the loan agreement.
- (3) Foreclosure proceedings have been or are expected to be initiated.
- (4) The credit-worthiness of the borrower is in doubt because of pending or actual bankruptcy proceedings, the filing of liens against his assets, etc.
- (5) Cost overruns and/or delays in construction cast doubt on the economic viability of the project.
- (6) The loan has been renegotiated.

These conditions may also be an indication that an allowance for losses should be provided.

.36 The Division supports the view that the discontinuance of interest revenue recognition is related to the question of realization and, consequently, such recognition should not be resumed, nor should unrecorded interest be recognized, until it is evident that the principal and interest will be collected.

.37 Some believe that even though the recognition of interest is discontinued, interest revenue should be "grossed up" with an offsetting charge to an expense account. They believe that this presentation will more clearly reflect the planned income from the portfolio as well as the deviations, in the form of provisions for possible losses, from that plan.

.38 Others maintain that since the interest recognition was discontinued because realization was doubtful, it would not be appropriate to include such amounts in interest revenue in the financial statements because such a presentation would contradict economic reality. The Division supports this view.

COMMITMENT FEES

.39 A commitment fee can be defined generally as any fee paid by a potential borrower to a potential lender for a promise

to lend money in the future. Recording commitment fees is complicated by the fact that some commitments (such as many gap and stand-by commitments) are not expected to be funded.

.40 A REIT may enter into a commitment agreement without having specifically earmarked funds to honor that commitment and it may have no expectation of ever having to honor the commitment. However, circumstances beyond the control of the REIT can change drastically and the REIT may be called upon to honor the commitment.

.41 While the Division agrees that it may be possible to distinguish between commitments which are expected to be funded and those which are not, it believes that it is not possible to make such a distinction on a practical basis.

.42 The available alternatives for the recognition of income from commitment fees are listed below.

- (1) Immediate recognition
- (2) Deferral and amortization—
 - (a) Over the commitment period
 - (b) Over the combined commitment and loan period
 - (c) Over the loan period
- (3) Deferral with immediate recognition when it is clear the commitment will not be funded or with recognition as “points” when the commitment is funded

.43 In general, industry practice has been to recognize commitment fees immediately upon receipt.

.44 Those who would defer the fee over the commitment period—whether amortizing it during that period or making a decision as to appropriate accounting at the end of that period—relate the fee to the commitment itself. Those who would defer the fee and amortize it over the loan period consider the fee an adjustment of the interest on the loan.

.45 Others argue that the fee may be a combination of an adjustment of interest, a fee for ear-marking funds, and/or an offset to the underwriting costs. They believe it is not practicable to separate the components and amortizing the fee over the combined commitment and loan period more closely accounts for all three components on an overall basis.

.46 The Division believes that this latter view should now be regarded as appropriate for a REIT. The straight-line

method of amortization should be used during the commitment period and the interest method should be used for the remaining balance during the loan period.¹ Deferred commitment fees should be taken into income at the end of the commitment period if the loan is not funded.

OPERATING SUPPORT OF THE REIT BY THE ADVISER

.47 Various methods are or have been employed by advisers to insure a certain return to the REIT for certain periods. Some of these methods are summarized below.

- (1) Purchasing a loan or a property at an amount in excess of market value
- (2) Forgiving indebtedness
- (3) Reducing advisory fees
- (4) Providing required compensating balances
- (5) Making outright cash payments

.48 In situations of this type, few would challenge the need for disclosure of the nature of the relationship between the REIT and its adviser and the nature and amount of the transactions between them. The accounting for the transaction, however, is not quite as clear.

.49 Some believe that operating support given to a REIT by its adviser can be determined to be either income or a contribution to capital on the basis of the form of the transaction.

.50 Others hold that such support should always be accounted for as income since it is difficult, if not impossible, to distinguish items of income from capital contributions. In some cases, for example, determining what the terms of an "arms-length" transaction would be might pose significant problems. Distinguishing between the types of operating support would also pose problems—why, for example, should a loan purchased at more than market value by the adviser be viewed differently from a reduction in the advisory fee?

.51 The Division believes that in the present framework of generally accepted accounting principles, appropriate account-

¹ If the commitment period were 24 months and the loan period were 25 years (300 months), monthly amortization during the commitment period would be $1/324$ of the commitment fee.

ing by a REIT for operating support from its adviser would include the following:

- (1) Adjustment of any assets (or liabilities) which will be transferred between the companies to current market value as of the date of the transaction.
- (2) Recognition, as income or as a reduction of advisory fees, of the operating support effectively obtained, with full disclosure of (a) the relationship between the parties and (b) the nature and amount of the transactions.

.52 The effect of such transactions, when material, should be reported separately in the income statement.

* * * * *

.53 APPENDIX A: ILLUSTRATION A

Purpose of Illustration

This appendix illustrates the accounting by a REIT for a loan on a project in the development stage when the developer is unable to complete the project. Evaluation of the carrying value of the loan requires the determination of the estimated selling price of the property and estimated costs to complete construction, to carry the project to the point of disposition, and to dispose of the property. The required allowance for loan losses is determined by comparing the loan receivable balance with the discounted value of estimated future net cash receipts and disbursements.

Assumptions

• Loan receivable balance at evaluation date—	\$ 20,500,000
• Estimated selling price of the property when completed in three years, reduced by estimated costs of disposal—.....	\$ 35,000,000
• Construction and carrying costs to complete, exclusive of interest—	
Year 1 (\$416,667 monthly) \$5,000,000	
Year 2 (\$250,000 monthly) 3,000,000	
Year 3 (\$ 83,333 monthly) 1,000,000	\$ 9,000,000

• Capitalization of REIT—	
Debt (average rate is 12%).....	\$300,000,000
Equity	60,000,000
Total	<u>\$360,000,000</u>

Accordingly, the average cost of all capital is 10% (12% of \$300,000,000 ÷ \$360,000,000).

- Construction and carrying costs are incurred ratably throughout each year. There is no occupancy prior to disposition.
- The REIT intends to support the project until disposition and to recover its loan on a work-out basis, and it has the financial capacity to do so.

Determination of Required Allowance for Loan Losses

Loan receivable balance	\$20,500,000
Less present value of estimated future net cash receipts and disbursements, exclusive of interest, at the average cost of all capital (10%) (Note a).....	17,870,000
Required allowance for loan losses	<u>\$ 2,630,000</u>
* * * * *	

Computational Notes (Note b)

Present value of estimated future cash receipts (\$35,000,000 × .7417) =	\$25,960,000
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 turnover. 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
	<hr/>	<hr/>
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
	<hr/>	<hr/>
	\$4,217,000	\$4,474,000
	<hr/>	<hr/>

Statements of Position

	<i>Assumption 1</i>	<i>Assumption 2</i>
Required allowance for loan losses.....	\$ 283,000	\$ 26,000
	* * *	* * *

Computational Notes

Present value of selling price—

Estimated selling price	\$4,620,000	\$4,620,000
----------------------------------	-------------	-------------

Present value factors—

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

Present value of net operating cash flow, before debt service—

<i>Year 1</i>		
Monthly cash flow	\$ 4,400	\$ 4,400
Present value factor	11.4958	5.8625
		\$ 26,000
Monthly cash flow		\$ 4,400
Present value factor		(5.9306 × .9802)
		\$ 26,000
	\$ 51,000	\$ 52,000

<i>Year 2</i>	<i>Assumption 1</i>	<i>Assumption 2</i>
Monthly cash flow	\$ 21,400	\$ 21,400
Present value factor	(11.4958 × .9234)	(11.7440 × .9609)
	\$ 227,000	\$ 241,000
	\$ 278,000	\$ 293,000

Note—See notes (a) and (b) on page 17,916.

.55 APPENDIX C: PRESENT VALUE FACTORS

Present Value of \$1

<i>Annual Rate</i>	<i>Periods *</i>	<i>Factor</i>
10%	12	.9052
10%	24	.8194
10%	36	.7417
8%	6	.9609
8%	12	.9234
8%	24	.8526
4%	6	.9802
4%	12	.9609
4%	18	.9419

Present Value of \$1 Per Period

<i>Annual Rate</i>	<i>Periods *</i>	<i>Factor</i>
10%	12	11.3745
8%	6	5.8625
8%	12	11.4958
4%	6	5.9306
4%	12	11.7440

* Interest compounded monthly.

ACCOUNTING STANDARDS DIVISION

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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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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.

➤→ *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 projections¹ 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

¹ 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.²

.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?"

² 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 statements³ expected to be issued, but, at a minimum, the presentation should consist of certain specific information (see below) obtained from such a financial forecast.

³ 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

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RICHARD C. LYTLE, Director, Accounting Standards	THOMAS P. KELLEY, Assistant 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.

* See also FASB Statement No. 63, *Financial Reporting by Broadcasters*, June 1982.

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
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

* See also FASB Statement No. 63, *Financial Reporting by Broadcasters*, June 1982.

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**

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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 PERNER
Chairman
Accounting Standards Task Force
on Real Estate Accounting

cc: Securities and Exchange Commission

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* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

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

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

** 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?

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982, and FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.

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
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➤➤➤ → *The next page is 18,131.* ← ➤➤➤

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.

Statements of Position

- 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.

* See also FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*, November 1981.

.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.¹ 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

¹ 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 was discussed in Statement No. 75-1, *Revenue Recognition When Right of Return Exists*. That Statement was withdrawn when the FASB issued Statement of Financial Accounting

Standards No. 48, *Revenue Recognition When Right of Return Exists*, which states that:

6. If an enterprise sells its product but gives the buyer the right to return the product, revenue from the sales transaction shall be recognized at time of sale only if *all* of the following conditions are met:
 - a. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
 - b. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
 - c. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
 - d. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.²
 - e. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
 - f. The amount of future returns³ can be reasonably estimated (paragraph 8).

Sales revenue and cost of sales that are not recognized at time of sale because the foregoing conditions are not met shall be recognized either when the return privilege has substantially expired or if those conditions subsequently are met, whichever occurs first.

7. If sales revenue is recognized because the conditions of paragraph 6 are met, any costs or losses that may be expected in connection with any returns shall be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies*. Sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns.

8. The ability to make a reasonable estimate of the amount of future returns depends on many factors and circumstances that will vary from one case to the next. However, the following factors may impair the ability to make a reasonable estimate:

- a. The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand

- b. Relatively long periods in which a particular product may be returned
- c. Absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies or relationships with its customers
- d. Absence of a large volume of relatively homogeneous transactions

The existence of one or more of the above factors, in light of the significance of other factors, may not be sufficient to prevent making a reasonable estimate; likewise, other factors may preclude a reasonable estimate.

²This condition relates primarily to buyers that exist "on paper," that is, buyers that have little or no physical facilities or employees. It prevents enterprises from recognizing sales revenue on transactions with parties that the sellers have established primarily for the purpose of recognizing such sales revenue.

³Exchanges by ultimate customers of one item for another of the same kind, quality, and price (for example, one color or size for another) are not considered returns for purposes of this Statement.

[.23—.24] [Deleted]

.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 FASB Statement No. 48 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

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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.² 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 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.

² See ARB No. 43, Chapter 4, for guidance.

- (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 unrecovered 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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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.

* See also FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, September, 1982.

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,



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.

* See also FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, September 1982.

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,¹ 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.

¹ 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.² The rate used to calculate the present value should be an appropriate current interest rate.³

² 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.

³ 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

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AICPA Staff

Thomas P. Kelley, Director
Accounting Standards

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Section 10,130**Statement of Position 76-3
Accounting Practices for
Certain Employee Stock
Ownership Plans****[Recommendation to the Financial Accounting Standards Board]****AICPA****American Institute of Certified Public Accountants**

1211 Avenue of the Americas New York New York 10036 (212) 575 6200

December 20, 1976

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices for Certain Employee Stock Ownership Plans (ESOPs). It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement deals primarily with accounting and reporting issues that have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company or that issue notes to existing shareholders in exchange for shares of stock. However, certain conclusions in the Statement are also applicable to ESOPs that have not entered into such transactions.

The Statement's major recommendations are briefly summarized below:

- An obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements.
- The offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity.

- The liability recorded by the employer and the offsetting debit should both be reduced as the ESOP makes payments on the debt.
- The amount contributed or committed to be contributed to an ESOP with respect to a given year should be charged to expense by the employer; the compensation and interest elements of the contribution should be separately reported.
- All shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. Dividends paid on those shares should be charged to retained earnings.
- Any additional investment tax credit should be accounted for as a reduction of income tax expense in the year in which the contribution to the ESOP is charged to expense.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,



Raymond C. Lauer
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING PRACTICES FOR CERTAIN EMPLOYEE STOCK OWNERSHIP PLANS

INTRODUCTION

.01 The Employee Retirement Income Security Act of 1974 describes an Employee Stock Ownership Plan (ESOP) as a qualified stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in "qualifying employer securities."¹ Qualifying employer securities include the employer's stock and its other marketable obligations. The essential differences between an ESOP and other qualified stock bonus plans are that (a) an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities and (b) the employer may be permitted to increase his maximum allowable investment tax credit by as much as an additional 1½% if that amount is contributed to an ESOP.

.02 In some cases, funds are borrowed from a bank or other lender by the ESOP and are used to acquire shares of stock in the employer company. The stock may be outstanding shares, treasury shares, or newly issued shares, and is held by the ESOP until it is distributed to the employees. (In some cases, an ESOP may issue notes to existing shareholders in exchange for qualifying employer securities.) The stock may be allocated to individual employees even though it may not be distributed to them until a future date. The debt of the ESOP is usually collateralized by a pledge of the stock and by either a guarantee of the employer or a commitment by the employer to make

¹ Employee Retirement Income Security Act of 1974, Title II, Subtitle B, Section 2003.

future contributions to the ESOP sufficient to meet the debt service requirements. The employer company makes annual contributions to the ESOP that are deductible for tax purposes, subject to the limitations of the Internal Revenue Code. Cash contributions and dividends received are used by the ESOP to:

- (a) Satisfy the annual amortization of the outstanding debt principal.
- (b) Satisfy the annual interest costs on such debt.
- (c) Obtain short-term investments to provide for liquidity.
- (d) Pay other expenses.
- (e) Acquire additional shares of the employer company's stock, to the extent of the excess, if any, over that required by (a) through (d) above.

.03 Several accounting and reporting issues have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company, or that issue notes to existing shareholders in exchange for shares of stock.² These issues are being dealt with in practice in different ways. This Statement of Position has been issued because the Division believes it is desirable to narrow the range of alternative accounting practices in this area.

.04 Final regulations clarifying the rights and duties of the parties affected by an ESOP have not been issued by the Internal Revenue Service. Readers of this Statement of Position should also be cognizant of the content of such regulations, when they are issued.

ACCOUNTING FOR AN OBLIGATION OF AN ESOP GUARANTEED BY THE EMPLOYER

Recording an ESOP's Obligation in the Employer's Financial Statements

.05 The Division believes that an obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the

² This Statement of Position does not deal directly with ESOPs that might invest in qualifying employer securities other than equity securities.

debt service requirements. The employer's guarantee or commitment is, in substance, the assumption of the ESOP's debt and the related obligation to reduce that debt. The employer has assumed these obligations either (a) to buy back its own shares (in the case where the ESOP uses the loan proceeds to acquire previously outstanding shares) or (b) to finance additional working capital or other fund needs (in the case where the ESOP uses the loan proceeds to acquire previously unissued or treasury shares from the employer).

.06 It does not follow from the above that assets held by an ESOP should be included in the financial statements of the employer. Ownership of these assets rests in the employees, not in the employer.

Recording the Offsetting Debit to the Recorded Liability

.07 The Division believes that the offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity. Therefore, when new shares are issued to the ESOP by the employer, an increase in shareholders' equity should be reported only as the debt that financed that increase is reduced. (The offsetting debit in shareholders' equity in this case is akin to the unearned compensation discussed in APB Opinion No. 25, paragraph 14.) When outstanding shares, as opposed to unissued shares, are acquired by the ESOP, shareholders' equity should similarly be reduced by the offsetting debit until the debt is repaid.

Reducing the Recorded Liability

.08 The Division believes that the liability recorded by the employer should be reduced as the ESOP makes payments on the debt. The liability is initially recorded because the guarantee or commitment is in substance the employer's debt. Therefore, it should not be reduced until payments are actually made. Similarly, the amount reported as a reduction of shareholders' equity should be reduced only when the ESOP makes payments on the debt. These two accounts should move symmetrically.

MEASURING COMPENSATION EXPENSE

.09 The Division believes that the amount contributed or committed to be contributed to an ESOP with respect to a given year should be the measure of the amount to be charged to ex-

pense by the employer.³ Such contributions measure the amount of expense irrevocably incurred whether or not they are used concurrently to reduce the debt guaranteed by the employer.

.10 Since the debt of the ESOP is, in substance, the employer's debt, the Division believes that the employer should report separately the compensation element and the interest element of the annual contribution, and should disclose the related interest rate and debt terms in the footnotes to the financial statements. However, a significant minority within the Division believes that the entire annual contribution should be reported as compensation expense.

REPORTING DIVIDENDS PAID AND EARNINGS PER SHARE

.11 The Division believes that all shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. An ESOP is a legal entity holding shares issued by the employer, whether or not those shares have been allocated to employee accounts.

.12 Dividends paid on shares held by an ESOP should be charged to retained earnings. Such dividends should not be included at any time in compensation expense.

.13 A minority within the Division believes that when trust debt proceeds are transferred to the employer corporation, a transaction of a predominantly financing nature has occurred. The minority believes that shares should be considered outstanding for earnings per share calculations only to the extent that they become constructively unencumbered by repayments of debt principal. To do otherwise, according to this minority view, would result in an inconsistent and initially excessive effect on earnings per share in that the total number of shares purchased by the ESOP would be immediately included in the calculation of earnings per share, even though the related compensation expense would be spread over a period of time on the basis of the employer's contribution to the trust. Consistent with this position, the minority would also charge dividends to retained earnings only to the extent that trust shares are unencumbered. Any remaining balance would be reported as additional compensation expense in the period the dividends were declared.

³ This conclusion is also applicable to ESOPs that have not borrowed funds from a bank or other lender (or issued notes to existing shareholders) to acquire shares of stock in the employer company.

OTHER MATTERS

Investment Tax Credit

.14 The Division believes that the additional investment tax credit should be accounted for (to the extent that it is available and utilized) as a reduction of income tax expense in the same year in which the contribution to the ESOP is charged to expense, irrespective of the accounting for the normal investment tax credit on property acquisitions.⁴ This additional credit arises from the contribution to the ESOP, not solely from the property acquisitions of the employer.⁵

Applicability of APB Opinion No. 11

.15 Excess contributions, as defined, made in any one year may be carried over to future periods for income tax purposes. The Division believes that the financial statements of the employer should reflect the tax effect of timing differences in accordance with APB Opinion No. 11.⁶

ACCOUNTING STANDARDS DIVISION

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Accounting Standards Task Force On Employee Stock Ownership Plans

Harry F. Reiss, Jr., Chairman	Fred L. Tepperman
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Accounting Standards

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⁴ See footnote 3.

⁵ See also Section 101(c) of the Revenue Act of 1971.

⁶ See footnote 3.

Section 10,140***Statement of Position 77-1
Financial Accounting and
Reporting by Investment Companies*****[Proposal to Financial Accounting Standards Board to Amend AICPA
Industry Audit Guide on Audits of Investment Companies]****AICPA****American Institute of Certified Public Accountants**

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.

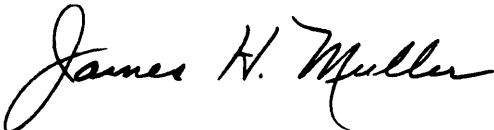
The advent of listed options has increased trading volume significantly, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Statement recommends that the sections of the Guide dealing with put and call options should be 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

»»»→ *The next page is 18,265.* ←«««

NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Task Force believes would be in the public interest.

Accounting Standards Task Force
on Investment Companies

JAMES H. MULLER, *Chairman*
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JOHN WOODCOCK, JR.

THOMAS P. KELLEY, *Director*
Accounting Standards

FINANCIAL ACCOUNTING AND REPORTING BY INVESTMENT COMPANIES

Proposed Amendment to Industry Audit Guide

INTRODUCTION

.01 The AICPA Industry Audit Guide, *Audits of Investment Companies*, notes that "changes in the rules, regulations, practices, and procedures of the investment company industry have been frequent and extensive in recent years" and that "further changes are under consideration." A number of changes and new developments have taken place since the Guide was published in 1973 which the Accounting Standards Division believes should be reflected in an amendment to the Guide.

.02 This proposed amendment presents the Division's views on the following matters:

- Money-market funds (an addition to the Guide)
- Put and call options (supersedes discussion in the Guide)
- Expenses during the development stage (an addition to the Guide)
- Amortization of deferred costs (an addition to the Guide)
- Valuation of short-term investments (an amendment to the Guide)

.03 The Guide includes collective trust funds within its general definition of investment companies, but has no discussion of regulatory and tax matters specifically applicable to such funds. Although collective trust funds are not investment companies within the definition of the Investment Company Act of 1940 and are not regulated under the Securities Acts, the accounting and auditing discussions in the Guide are applicable to such funds, where relevant. In addition, the auditor should be familiar with Regulation 9 of the Comptroller of the Currency, which is the regulatory standard for most collective funds operated by banks, and Subchapter H of the Internal Revenue Code, which contains rules for the specialized tax treatment of collective funds.

MONEY-MARKET FUNDS

Background

.04 Money-market funds are open-end management investment companies that invest principally in money-market instruments (short-term government obligations, commercial paper, bankers' acceptances, certificates of deposit, and so forth) with the objective of preserving capital, maintaining liquidity, and obtaining current income. As such, money-market funds are subject to the provisions of the AICPA Industry Audit Guide, *Audits of Investment Companies*.

.05 At the time the Guide was published in October 1973, only a few money-market funds were in operation, and the Guide did not discuss such funds specifically. However, many more have commenced operations since that date, and the Division believes that specific guidance for money-market funds is now desirable.

Distribution Policies

.06 Many money-market funds declare dividends daily, thereby maintaining net asset value per share at or near a fixed amount, depending on which of the following distribution policies is adopted.

<u>Distribution Policy</u>	<u>Effect on Net Asset Value per Share</u>
(a) Define income for dividend purposes as the sum of net investment income, net realized gain (loss), and net unrealized appreciation (depreciation). If income, as defined, is a negative amount for any day, that amount is first offset against undistributed dividends accrued during the month in each shareholder's account. If a negative amount remains in a shareholder's account, outstanding shares are reduced by treating each such shareholder as having contributed shares to the fund to the extent of such negative amount.	Net asset value remains fixed.
(b) Define income as in (a) above, but take no action for any day in which such income is a negative amount.	Net asset value remains fixed unless income, as defined, is a negative amount, in which case net asset value will be less than the fixed amount until restored to the fixed amount through subsequent income, as defined.

<u>Distribution Policy</u>	<u>Effect on Net Asset Value per Share</u>
(c) Define income for dividend purposes as the sum of net investment income and net realized gain (loss).	Net asset value varies from the fixed amount to the extent of unrealized appreciation or depreciation. Also, it is reduced if income, as defined, is a negative amount that is not offset by unrealized appreciation (net realized loss exceeds net investment income and unrealized appreciation).
(d) Declare daily dividends from net investment income only; distribute net realized gain annually.	Net asset value varies from the fixed amount to the extent of the sum of undistributed realized gain (loss) and unrealized appreciation (depreciation).

.07 Long-term capital gains, as defined in the Internal Revenue Code, may be distributed only once every 12 months unless a specific exemption is obtained.¹ Therefore, a fund that expects to realize long-term gains and that wishes to follow distribution policy (a), (b), or (c) will need to request exemption from Section 19(b) of the 1940 Act to avoid adverse consequences.

.08 See paragraphs .46-.47 of this Statement for a discussion of the valuation of short-term investments.

Statement of Changes in Net Assets

.09 A modification of the format suggested in the Guide for the Statement of Changes in Net Assets is required to report clearly the effects of following one of the distribution policies described in (a), (b), or (c) in the preceding section.

.10 A fund that follows distribution policy (a) or (b) should include a subtotal for net investment income and net realized gain (loss) and unrealized appreciation (depreciation) in the Statement of Changes in Net Assets. This subtotal represents income as defined for dividend purposes.

¹ Section 19(b) and Rule 19b-1 of the Investment Company Act of 1940.

.11 The following format is appropriate for the Statement of Changes in Net Assets (shown in part) of a money-market fund that has adopted distribution policy (a) or (b).

From Investment Activities	<u>19X1</u>	<u>19X0</u>
Net investment income	\$100,000	\$80,000
Net realized gain (loss) on investments	2,000	(1,000)
Increase (decrease) in unrealized appreciation of investments	(3,000)	1,000
Total available for distribution	<u>\$ 99,000</u>	<u>\$80,000</u>
Dividends declared	99,500	80,000
Decrease in assets derived from investment activities ²	<u>\$ (500)</u>	<u>—</u>

.12 The following format is suggested for the Statement of Changes in Net Assets (shown in part) of a money-market fund that follows distribution policy (c); that is, it distributes the sum of net investment income and net realized gain or loss daily.

From Investment Activities	<u>19X1</u>	<u>19X0</u>
Net investment income	\$100,000	\$80,000
Net realized gain (loss) on investments	2,000	(1,000)
Total available for distribution	<u>\$102,000</u>	<u>\$79,000</u>
Dividends declared	(102,000)	(79,000)
Increase (decrease) in unrealized appreciation of investments	(3,000)	1,000
Increase (decrease) in net assets derived from investment activities	<u>\$ (3,000)</u>	<u>\$ 1,000</u>

² A decrease in net assets derived from investment activities would be reported by a company following distribution policy (b) only if the company incurred a net loss (realized and unrealized) on investments that was not offset by net investment income and net gains (realized and unrealized) prior to the end of the reporting period.

.13 Money-market funds that follow distribution policy (d), or that do not declare dividends daily, should follow the presentation on page 101 of the Guide.

Supplementary Information

.14 The per-share data included in the financial statements as "Supplementary Information" should be presented on a basis consistent with the presentation of the Statement of Changes in Net Assets, as illustrated or discussed above.³ A fund that follows distribution policy (a) and that has treated each shareholder as having contributed shares to the fund when income, as defined, is a negative amount, should include an additional line item in the per-share data to show the effect of such action.

.15 The investment policies of money-market funds are such that gains and losses, whether realized or unrealized, are usually incidental to the realization of investment income. Also, the dividend policy adopted by a fund should have no effect on the reported ratio of income to average net assets, because the purpose of the ratio is to indicate the effective rate of earnings, regardless of when the earnings are distributed. Accordingly, the most significant ratio for a money-market fund to report is the ratio of net investment income, plus or minus realized and unrealized gains or losses, to average daily net assets. When supplementary information is provided by a money-market fund, this ratio should be reported instead of the ratio of net investment income to average net assets, which is included in the illustration of "Supplementary Information" in the Guide.

.16 It may be appropriate for a fund that distributes only net investment income (distribution policy (d)) to provide a breakdown of the ratio, in a footnote or parenthetically, indicating the portion applicable to realized and unrealized gains or losses, if they are significant.

.17 When yield information is presented as "Supplementary Information" or elsewhere in the financial statements, a description of the method of computation should be provided.

³ Income (as defined) per share should be based on the per-share dividends declared during the period and prorated by components based on the amounts shown in the Statement of Operations. For example, a fund following distribution policy (a) or (b) would apportion its per-share income (as defined) between net investment income and realized and unrealized gain (loss).

Reporting Gains and Losses

.18 When short-term investments, including discounted instruments, are sold prior to maturity, realized gains and losses should be recorded as such, based on the difference between the proceeds from sale and cost (amortized cost in the case of discounted instruments). However, net realized gains or losses are ordinarily not significant in relation to the total dollar amount of sales of money-market instruments. Further, such gains or losses are rarely significant in relation to the results of operations of a money-market fund. Accordingly, except in unusual circumstances, a money-market fund need not report the proceeds from sales and the cost of securities sold in the Statement of Operations; it need report therein only the amount of net realized gain or loss.

.19 Changes in unrealized appreciation or depreciation should be reported following the presentation on page 100 of the Guide.

Federal Income Taxes

.20 A fund that includes unrealized appreciation or depreciation in dividends may have distributed more or less than its taxable income in a particular year. Accordingly, a fund that follows such a policy should pay particular attention to the provisions of the Internal Revenue Code relating to the distribution of taxable income, as discussed more fully in chapter 5 of the Guide.

PUT AND CALL OPTIONS

Background

.21 An active public market has been developed in listed call options, and trading in listed put options is expected in early 1977. Although there has been an over-the-counter market in options for many years and the public has participated to some degree, the advent of listed options has increased trading volume significantly, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Division believes that the sections of *Audits of Investment Companies* covering options should be amended to give appropriate guidance with respect to an investment company that purchases or sells options. This Statement of Position supersedes the following sections of the Guide:

- Valuation of Put and Call Options Purchased (chapter 3, “Investment Accounts,” page 37)
- Valuation of Put and Call Option Contracts Written by the Investment Company (chapter 3, “Investment Accounts,” page 38)
- Put and Call Options (chapter 5, “Taxes,” page 69)

Option Trading

.22 The following glossary of terms should be helpful in understanding the mechanics of option trading.

Exchange-Traded Option. A put or call option traded on an exchange and settled through the facilities of an exchange. It gives the buyer of the option (“holder”) the right to sell to (put) or buy from (call) the seller (“writer”) the number of shares or other units of the underlying security covered by the option at the stated exercise price prior to the fixed expiration date of the option. The designation of an option includes the underlying security, the expiration month, and the exercise price; for example, “XYZ July 50” means that a unit of trading (typically 100 shares) of XYZ stock may be sold or purchased at \$50 per share until the option expires on the expiration date in July. Options of like designation are said to be of the same “series.”

Underlying Security. The security subject to sale or purchase upon the exercise of the option.

Unit of Trading. The number of units of the underlying security designated as the subject of a single option. In the absence of any other designation, the unit of trading for a common stock is 100 shares.

Exercise Price. The price per share or other unit at which the holder of an option may sell or purchase the underlying security upon exercise. The exercise price is sometimes called the “striking price.”

Expiration Date. The last day on which an option may be exercised.

Premium. The aggregate price of an option agreed upon between the buyer and writer or their agents.

Opening Purchase Transaction. A transaction in which an investor becomes the holder of an exchange-traded option.

Opening Sale Transaction. A transaction in which one becomes the writer of an exchange-traded option.

Closing Purchase Transaction. A transaction in which a writer of an exchange-traded option liquidates his position as a writer by "purchasing," in a transaction designated as a closing purchase transaction, an option having the same terms as the option previously written. Such a transaction has the effect, upon payment of the premium, of canceling the writer's pre-existing position instead of resulting in the issuance of an option.

Closing Sale Transaction. A transaction by which a holder of an option liquidates his position as a holder by "selling," in a transaction designated as a closing sale transaction, an option having the same terms as the option previously purchased. Such a transaction has the effect of liquidating the holder's pre-existing position instead of resulting in the holder's assuming the obligation of a writer.

Covered Writer. A writer of a call option who, as long as he remains a writer, owns the shares or other units of the underlying security covered by the option. The writer of a put is "covered" only when he purchases an option on the same underlying security with an exercise price equal to or greater than that of the option written.

Uncovered Writer. A writer of an option who is not a covered writer; sometimes referred to as "naked."

Option Writing

.23 As consideration for the rights and obligations represented by an option, the buyer pays, and the writer receives, a premium. The premium is determined in the exchanges' option markets on the basis of supply and demand, reflecting factors such as the duration of the option, the difference between the exercise price and the market price of the underlying security, and the price volatility and other characteristics of the underlying security. A covered writer of a call option gives up, in return for the premium, the opportunity for profit from an increase in the price of the underlying security above the exercise price as long as the option obligation continues, but he retains the risk of loss should the price of the security decline. Since the option holder may exercise the option and purchase the securities at the designated price at any time prior to the ex-

piration date of the option, the option writer has no control over the date of sale.

.24 An uncovered writer of a call option assumes, in return for the premium, the obligation to provide the option holder with the underlying securities upon exercise of the option. The uncovered writer, therefore, may have a substantial risk of loss should the price of the security increase, but he has no risk of loss should the price of the security decrease.

.25 As long as a secondary market in options remains available on each of the exchanges, the writer of an option traded on an exchange is able to liquidate his position prior to the exercise of such option by entering into a closing purchase transaction. Such a transaction has the effect of canceling the writer's pre-existing position. The cost of such a liquidating purchase, however, can be greater than the premium received upon writing the original option.

.26 Because the purchaser or writer has the ability to enter into a closing transaction, the option originally written may never be exercised. The exercise of an exchange-traded option takes place only through the Options Clearing Corporation (OCC), which is the obligor on every option, by the timely submission of an exercise notice by the clearing broker acting on behalf of the exercising holder. The exercise notice is then "assigned" by the OCC to a clearing broker acting on behalf of a writer of an option of the same series as the exercised option. This broker is then obligated to deliver the underlying security against payment of the aggregate exercise price. The assigned broker is randomly selected from clearing members having accounts with the OCC with options outstanding of the same series as the option being exercised.

.27 Most investment companies deposit securities underlying the options written in order to guarantee delivery in the event the option is exercised.

Accounting

.28 Portfolio securities underlying call options should be reported at value, determined in accordance with the provisions of the Guide, and reflected in net asset value accordingly. Premiums received by an investment company from the sale of outstanding call options should be included in the liability section of the Statement of Assets and Liabilities as a deferred credit

and subsequently adjusted to the current market value (marked-to-market) of the option written. For example, if the current market value of the option exceeded the premium received (which should be shown parenthetically in the Statement of Assets and Liabilities), the excess would be an unrealized loss and, conversely, if the premium exceeded the current market value, such excess would be an unrealized gain. Current market value of exchange-traded options should be the last sales price or, in the absence of a transaction, the mean between the closing bid and ask prices, or the ask prices, in accordance with the valuation policy followed by the fund. The change in unrealized depreciation or appreciation resulting from the mark-to-market may be included with unrealized gains or losses on the portfolio in the Statement of Operations and Statement of Changes in Net Assets, with disclosure as to the amount, or it may be reported as a separate line item.

.29 With respect to covered options, disclosure, summarized by security, should be made of the description and number of shares of portfolio securities covering outstanding options and the market value of the options. Disclosure should also be made of the aggregate market value of the securities or other assets deposited as collateral. With respect to uncovered options, disclosure should be made of the description and quantity of securities under option, the expiration dates and exercise prices, the current market prices of the securities covered by the options, and the assets deposited in escrow with respect to such options.

.30 Subsequent to the sale of a call option, any one of three events may occur: the option may expire on its stipulated expiration date; the writer may enter into a closing transaction; or the option holder may exercise his right to call the security. Either of the first two events results in a realized gain (or loss if the cost of the closing transaction exceeds the premium received when the option was sold) for the investment company option writer and should be accounted for as such. The third possible event results, in the case of a covered writer, in the sale of the underlying securities, unless the writer purchases like securities for delivery to the exercising holder. The proceeds should be increased by the amount of premium originally received, and realized gains or losses resulting from such sales should be accounted for in the conventional manner. If an uncovered option is exercised, the writer must purchase the under-

lying securities in order to meet his obligation to the option holder. In such situations, the writer's realized loss resulting from the simultaneous purchase and sale of the securities should be reduced by the premium originally received, and the net realized loss (or gain) should be accounted for in the conventional manner.

.31 The foregoing describes the accounting for the sale of call options. The same principles are applicable to the sale of put options.

.32 Actively traded put and call options purchased by an investment company should be accounted for in the same manner as marketable portfolio securities. The cost of portfolio securities acquired through the exercise of call options should be increased by the premium paid to purchase the call. The proceeds from securities sold through the exercise of put options should be decreased by the premium paid to purchase the put.

.33 Transactions in options not listed on a national exchange or not actively traded should be accounted for as described in the foregoing paragraphs, except that the determination of unrealized gain or loss during the contract period of the option must be based on the fair value of the option as determined by the investment company's board of directors. Among the many factors to be considered in the determination of fair value are the price of the underlying securities, the liquidity of the market, and the time remaining prior to expiration date.

Federal Income Taxes

.34 The following paragraphs are intended to supersede only that portion of chapter 5 of the Guide ("Taxes") dealing with put and call options. Reference to that chapter should be made for other information pertinent to the taxation of investment companies.

.35 For federal income tax purposes, premium income from the sale of options is deferred until expiration or exercise of the option, or until a closing purchase transaction takes place. If the option expires, the premium constitutes a short-term capital gain. If the option is exercised and the underlying securities are sold, the premium is added to the proceeds from the sale of the securities in determining capital gain or loss. Such gain or loss is short-term or long-term depending upon the holding period

of the underlying securities. If the option is closed in a closing purchase transaction, the difference between the amount paid for the option purchased and the premium received on the original sale is a short-term capital gain or loss.⁴

.36 Under the Internal Revenue Code, an investment company cannot qualify as a regulated investment company unless, among other things, less than 30 percent of its gross income is derived from gains from the sale or other disposition of securities held for less than three months (“30 percent rule”). Therefore, in order to be taxable as a regulated investment company, its ability to write options with exercise periods of less than three months or to effect closing purchase transactions within three months of writing options is restricted. For purposes of meeting this “three-month test,” the holding period for the sale of an option commences on the day it is written.

.37 An investment company must derive at least 90 percent of its gross income from dividends, interest, and gain from the sale or other disposition of stock or securities (“investment income”), in order to qualify as a regulated investment company in any taxable year. For tax purposes, income received from expired call options and from profits in executing closing purchase transactions for amounts less than the call premiums received qualifies as investment income.

EXPENSES DURING THE DEVELOPMENT STAGE

.38 The standards of financial accounting and reporting set forth in FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, are applicable to financial statements issued by investment companies that are in the development stage, as defined in the FASB Statement. The following paragraphs in this section discuss certain expenses that may be incurred by an investment company that is in the development stage.

.39 A newly formed investment company will incur organization expenses unless it is sponsored by a management company that has agreed to absorb these expenses. Organization expenses consist of expenses incurred in order to establish the company and legally equip it to engage in business. In recent years, a

⁴ The termination of a writing position that was established on or before September 1, 1976, by lapse of the option or by a closing purchase transaction, will produce ordinary income or loss.

significant number of no-load funds, particularly money-market funds, have borne their own organization expenses.

.40 An open-end investment company, which is organized to offer shares of capital stock to the public continuously and to invest the proceeds from sale of such capital stock, cannot be considered to be organized until it has registered securities with the Securities and Exchange Commission. Therefore, expenses incurred by a newly organized open-end investment company in preparing its initial registration statement and obtaining clearance of such registration statement by the SEC should be considered part of its organization expenses; expenses incurred after that registration statement has been declared effective by the SEC, such as printing a supply of prospectuses to be used for sales purposes, are not organization expenses.

.41 As stated in *Audits of Investment Companies*, "closed-end companies charge all registration fees against paid-in capital at the time the shares are sold." This Statement of Position does not modify that requirement.

.42 Once an investment company has been organized to do business, it usually engages immediately in its planned principal operations, that is, sales of capital stock and investment of funds. The training of employees, development of markets for the sale of capital stock, and similar activities are usually performed by the investment adviser or other agent, and in such cases the costs of these activities are not borne directly by the investment company. However, an investment company (particularly one that does not employ agents to manage its portfolio and perform other essential functions) may engage for a period of time in such activities, and may bear those costs directly during its development stage.

.43 As stated above, an investment company that is in the development stage is subject to the provisions of FASB Statement No. 7. Paragraph 10 of the FASB Statement notes that "generally accepted accounting principles that apply to established operating enterprises . . . shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred." Accordingly, the costs and expenses discussed in the preceding paragraphs should be accounted for in accordance with the generally accepted accounting principles that apply to established operating enterprises. Organization expenses of invest-

ment companies are usually deferred and amortized in financial statements prepared in conformity with generally accepted accounting principles.

AMORTIZATION OF DEFERRED COSTS

.44 Costs deferred by an investment company should be subject to the same assessment of recoverability that would be applicable to any established operating company. Such costs should be amortized to income over the period during which it is expected that a benefit will be realized. That period may vary according to the type of expense. Several costs are listed below.

Organization Expenses. Generally such expenses are amortized over a period of not more than 60 months from the date of commencement of operations. Straight-line or other acceptable methods of amortization may be utilized.

If such expenses are amortized on the basis of assets expected to be managed over the period selected, the projected growth rate initially used as the basis for establishing an amortization table should be reviewed frequently and adjusted, if necessary, to reflect actual experience.

Cost of Printing Prospectuses. Costs deferred in connection with printing a supply of prospectuses for sales purposes should be amortized, generally on a straight-line basis, over the period during which the prospectus may be used, which is limited to a period ending 16 months after the date of the latest audited financial statements. If during this period it becomes evident that the prospectus will be effective for a shorter period than originally anticipated, amortization should be accelerated so that no costs remain deferred at the end of such shorter period.

Registration Fees. Deferred SEC and state registration fees should be written off as the registered shares of stock are sold (but over not more than 60 months).

.45 The summary in the financial statements describing an investment company's significant accounting policies should cover the company's accounting for deferred costs.

VALUATION OF SHORT-TERM INVESTMENTS

.46 The discussion of the valuation of short-term investments on page 39 of the Guide states that "original cost plus amortized

discount or accrued interest . . . usually approximates market value.” This statement was made when holdings of short-term investments generally constituted a small portion of an investment company’s portfolio. It was not intended to modify the principle that “all investment companies should report their securities portfolio at value.” In all cases, the board of directors should be satisfied that investments, including short-term investments (money-market instruments), are carried at amounts that approximate market or fair value. Accordingly, the Division believes that the discussion entitled Short-Term Investments on page 39 of the Guide should be amended by the addition of the following paragraph:

Although the amortized cost of money-market instruments that mature within a relatively short period of time ordinarily approximates market value, it must be recognized that unusual events, such as the impairment of the credit standing of the issuer, can significantly affect the value of short-term investments regardless of the number of days to maturity. Changes in interest rates can also have a significant effect on the value of money-market instruments with longer terms to maturity. In such cases, amortized cost might not approximate the value of these investments. When amortized cost does not approximate value, the investments should be valued on the basis of quoted sales prices, bid and asked prices, or fair value based upon appraisals furnished by market makers or other appropriate evidence.

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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
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AICPA Staff:
Paul Rosenfield, *Director*
Accounting Standards
Gabriel V. Carifi, *Manager*
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

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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 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.¹

.04 Similarly, cost should no longer be used by not-for-profit hospitals for marketable equity securities. The carrying amount of a marketable equity security portfolio of a not-for-profit hospital that was previously carried at cost should now be the lower of its aggregate cost and market value, determined at the balance sheet date. The amounts by which the aggregate cost of each portfolio exceeds market value should be accounted for as valuation allowances.

.05 Marketable equity securities owned by a not-for-profit hospital should be grouped into separate portfolios, as indicated below, for the purpose of comparing aggregate cost and market value to determine carrying amount.

1. Marketable equity securities included in unrestricted funds should be grouped into separate portfolios according to the current or noncurrent classification of the securities.
2. Marketable equity securities included in different types of restricted funds should be grouped into separate portfolios according to types of funds (for example, portfolios of marketable equity securities included in various specific purpose funds should be grouped together but not with those in endowment funds).
3. The current portfolios of unrestricted funds of entities that are combined in financial statements should be treated as a single combined portfolio; the noncurrent unrestricted portfolios of those entities should also be treated as a single combined portfolio: similar restricted fund portfolios of entities that are combined in financial statements should be treated as single portfolios (for example, portfolios of marketable equity securities included in the various specific purpose funds of a not-for-profit hospital should be combined with the portfolios of marketable equity securities held in the various specific purpose funds of an entity whose financial statements are combined with those of the not-for-profit hospital).

¹ Reference should be made to paragraph 7 of FASB Statement No. 12 for definitions of the following terms: equity security, marketable, market price, market value, cost, valuation allowance, carrying amount, realized gain or loss, net unrealized gain or loss.

.06 If there is a change in a marketable equity security's classification between current and noncurrent assets in unrestricted funds, the security should be transferred between the corresponding portfolios at the lower of its cost and market values at the date of transfer. If market value is less than cost, the market value becomes the new cost basis, and the difference is accounted for as if it were a realized loss and is included in the nonoperating revenues section of the statement of revenues and expenses.

.07 Changes in the valuation allowance for a marketable equity securities portfolio included in current assets in unrestricted funds should be disclosed in the nonoperating revenues section of the statement of revenues and expenses. Changes in the valuation allowance for a marketable equity securities portfolio included in noncurrent assets in unrestricted funds or assets in restricted funds should be disclosed in the respective statements of charges in fund balances; accumulated changes in the valuation allowance for such portfolios should be disclosed in the appropriate fund balance in the balance sheet.

.08 If the hospital pools its investments (which could include investments of current and noncurrent unrestricted funds and investments of restricted funds), the cost of marketable equity securities in the fund(s) should be compared to the allocation of the market value of the pooled marketable equity securities for purposes of implementing the above recommendations. To apply those provisions properly, marketable equity securities and other investments must be accounted for separately.

.09 Income from investments of board-designated and other unrestricted funds and realized gains or losses on sales of investments of board-designated and other unrestricted funds should be included in the statement of revenues and expenses as nonoperating revenue of the period in which they are earned or incurred.

.10 Realized gains or losses on the sale of investments of endowment funds should be added to or deducted from endowment fund principal unless such amounts are legally available for other use or chargeable against other funds. Investment income of those funds should be accounted for in accordance with the donors' instructions—for example, as resources for specific operating purposes if restricted, or nonoperating revenue if not.

.11 Income and net realized gains or losses on investments of restricted funds other than endowment funds should be charged or credited to the respective fund balance unless such amounts are legally available for or chargeable against other funds. If such amounts are legally available for unrestricted purposes, they should be included in nonoperating revenue. Gains or losses on investment trading between unrestricted and restricted funds and between various categories of restricted funds (for example, between endowment and plant replacement funds) should be recognized as realized gains or losses and separately disclosed in the financial statements. Gains or losses resulting from transactions between various board-designated funds of the unrestricted fund should not be recognized.

.12 The following information with respect to owned marketable equity securities should also be disclosed either in the body of the financial statements or in the accompanying notes:

1. As of the date of each balance sheet presented, aggregate cost and market values for each separate portfolio into which marketable equity securities were grouped to determine carrying amount, with identification of which is the carrying amount.
2. As of the date of the latest balance sheet presented, the following segregated by portfolio—
 - a. Gross unrealized gains representing the excess of market value over cost for all marketable equity securities having such an excess in the portfolio.
 - b. Gross unrealized losses representing the excess of cost over market value for all marketable equity securities having such an excess in the portfolio.
3. For each period for which a statement of revenues and expenses is presented—
 - a. Net realized gain or loss included in nonoperating revenue.
 - b. The basis on which cost was determined in computing realized gain or loss (average cost or other method).

.13 The financial statements should not be adjusted for realized gains, losses, or changes in market prices with respect to marketable equity securities if such gains, losses, or changes occur after the date of the financial statements but before their issuance, except for the situation covered in the following para-

graph. However, significant net realized and net unrealized gains and losses arising after the date of the financial statements but before their issuance applicable to marketable equity securities owned at the date of the most recent balance sheet should be disclosed.

.14 For those marketable securities for which the effect of a change in carrying amount is included in the statement of changes in fund balances rather than in the statement of revenues and expenses, a determination should be made as to whether a decline in market value below cost as of the balance sheet date of an individual security is other than temporary. If the decline is judged to be other than temporary, the cost basis of the individual security should be written down to a new cost basis and the amount of the write-down should be accounted for as a realized loss. The new cost basis should not be changed for subsequent recoveries in market value.

.15 Unrealized gains or losses should not result in adjustment of financial statements, except for changes in the valuation allowance related to marketable equity securities and for declines in value that result from other than temporary impairment.

.16 The disclosures in Note 1 to the sample financial statements on page 48 of the *Hospital Audit Guide* should conform with the disclosures set forth in this amendment.

TRANSITION

.17 The subcommittee recommends that this amendment be applied to financial statements for fiscal years beginning on or after the first day of the first month following the date of this Statement and encourages earlier application. If the initial application of this Statement requires the establishment of a valuation allowance, financial statements previously issued should not be restated. If the establishment of a valuation allowance is required for a marketable equity securities portfolio included in current assets in unrestricted funds, the effect of the change should be included in the determination of the excess of revenue over expense for the period of the change in accordance with the provisions of APB Opinion 20. If the establishment of a valuation allowance is required for a marketable equity securities portfolio included in noncurrent assets in unrestricted funds or assets in restricted funds, the effect of the change should be presented in the statement of changes in fund balances.

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The subcommittee gratefully acknowledges the contributions made to the development of this Statement of Position by former members of the subcommittee, Robert A. Cerrone, William Freitag, and Robert F. Rosenstiel.

➤→ *The next page is 18,351.* ←➤

Section 10,170***Statement of Position 78-2
Accounting Practices of Real
Estate Investment Trusts*****[Proposal to Financial Accounting Standards Board to Amend Statement of Position 75-2]****AICPA****American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, New York 10036 (212) 575 6200

May 12, 1978

Donald J. Kirk
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting Practices of Real Estate Investment Trusts, an Amendment of Statement of Position 75-2, was prepared on behalf of the division by the AICPA's Committee on Real Estate Accounting for consideration of the Financial Accounting Standards Board and for such action as the board deems appropriate. It amends Statement of Position 75-2 to conform the recommendations of that statement to the provisions of Statement of Financial Accounting Standards 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience. The division would appreciate being advised on the board's proposed action on the

recommendations set forth in this statement of position.

Sincerely,

A handwritten signature in cursive script, appearing to read "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

* See also FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.

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,



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.

»»»→ *The next page is 18,373-3.* ←«««

* See also FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.

- 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.

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982, and FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.

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:¹

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.”

¹ 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.² 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

² 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.³

.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.

³ 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 executive 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*,⁴ 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.

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⁴Charles 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 Cost 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.

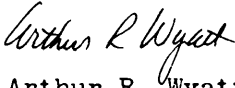
The statement is an interpretation of the AICPA accounting guide, Accounting for Profit Recognition on Sales of Real Estate, issued in 1973. It presents the division's recommendations on the application of the deposit, installment, and cost recovery methods in accounting for sales of real estate. Diverse methods of application of those accounting methods have

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

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,



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.

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

.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.¹

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

¹ 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* [See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.]

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.²

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

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982, and FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.

² 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.

ACCOUNTING STANDARDS DIVISION

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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

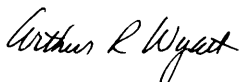
Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

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

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* See also FASB Statement No. 64, *Extinguishment of Debt Made to Satisfy Sinking-Fund Requirements*, an amendment of FASB Statement No. 4, September 1982.

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 refundings¹ of tax-exempt debt.² 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

* See also FASB Statement No. 64, *Extinguishment of Debt Made to Satisfy Sinking-Fund Requirements*, an amendment of FASB Statement No. 4, September 1982.

¹ 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*.

² *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.

† Superseded by FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, December 1982.

statement of position should be applied by entities for rate-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 26³ 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

³ 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.⁴ 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.

⁴ 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

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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>
Loss on Advance Refunding		
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)	48,000,000
		<hr/>
Loss on advance refunding		<u>\$10,492,521</u>
		<hr/>
Entries¹		
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		

¹ 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 ²	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 ²	3.5394%

² 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
			<u>\$75,250,000</u>
Total future cash requirements of old debt			
<u><u>\$75,250,000</u></u>			
Proceeds from sale of new debt			
	Revenue bonds	Special obligation bonds	Total
	<u> </u>	<u> </u>	<u> </u>
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)
	<u> </u>	<u> </u>	<u> </u>
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 3.5394 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

\$19,723,049

Debt service requirements of special obligation bonds

Principal \$17,150,479

Interest at 3% 2,572,570

\$19,723,049

Loss on Advance Refunding³

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/>	<hr/>
Loss on advance refunding		\$10,492,521
		<hr/> <hr/>

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-

³The 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 ⁴		
Cash invested	\$21,606,000	
Interest to be earned	8,494,000	30,100,000
		<u>30,100,000</u>
Total future cash to be provided from proceeds of new debt		<u>\$ 75,250,000</u>
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)
		<u>(1,507,479)</u>
Net proceeds of new debt to be invested		<u>\$ 58,492,521</u>

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.

⁴ Amounts will vary depending on the specific circumstances of the refunding.

Statements of Position

	Cash to be provided	Ratio of cash to be provided to total cash	Portion of refunded debt
	<u> </u>	<u> </u>	<u> </u>
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
			<u>48,000,000</u>
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.

➤➤➤ *The next page is 18,451.* ←➤➤➤

Section 10,210***Statement of Position 78-6
Accounting for Property and
Liability Insurance Companies****

**[Proposal to the Financial Accounting Standards Board to Amend
AICPA Industry Audit Guide *Audits of Fire and Casualty Insurance
Companies*]**

AICPA**American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

July 28, 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 Property and Liability Insurance Companies, has been prepared on behalf of the accounting standards division by the AICPA Insurance Companies Committee and approved by the AICPA Accounting Standards Executive Committee. It proposes amendments to the AICPA industry audit guide, Audits of Fire and Casualty Insurance Companies.

The statement of position presents the division's recommendations on significant accounting issues related to property and liability insurance companies and amends those sections of chapter 9 of Audits of Fire and Casualty Insurance Companies that discuss the accounting practices followed in the industry.

* See also FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, June 1982.

Representatives of the division are available to discuss this proposed statement of position with you or your representatives at your convenience.

Sincerely,

A handwritten signature in cursive script that reads "Arthur R. Wyatt". The signature is written in black ink and is positioned above the typed name.

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTE

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA subcommittees or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA subcommittee or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the subcommittee or task force believes would be in the public interest.

➤➤➤ → *The next page is 18,453-3.* ← ➤➤➤

ACCOUNTING FOR PROPERTY AND LIABILITY INSURANCE COMPANIES *

INTRODUCTION

.01 The AICPA Insurance Companies Committee is in the process of revising the AICPA industry audit guide, *Audits of Fire and Casualty Insurance Companies* (referred to in this statement of position as the guide). The term *property and liability insurance companies* is the current terminology used to describe fire and casualty insurance companies and, therefore, is used throughout this statement of position. The committee has reviewed the section of the guide dealing with variances between (a) generally accepted accounting principles and (b) practices prescribed or permitted by insurance regulatory authorities and has identified areas in which existing practice varies, including areas in which further clarification of the guide seems necessary, and certain areas that were not discussed in the guide. This statement of position amends the guide to clarify and update those sections reviewed.

.02 A discussion memorandum was issued in November, 1975, to obtain representative views on the appropriate accounting principles to be applied in the various areas under study from AICPA members, representatives of industry, and other interested parties. An exposure draft of a proposed statement of position was issued for comments on October 31, 1977. The responses to the discussion memorandum and exposure draft were considered in the preparation of this statement of position.

.03 In recent years, accountants, investors, and other users of financial statements have expressed concern over the acceptability of accounting alternatives for similar business transactions. The accounting standards division believes that it is not desirable to have alternative accounting methods in the property and liability insurance industry. Therefore, this statement of position expresses the division's conclusions on accounting methods that should be used in the areas in which alternatives exist, except for the issues of (a) whether loss reserves should be discounted, which is discussed in paragraphs .34 through .41, and (b) whether anticipated investment income should be considered in computing premium deficiencies, which is discussed in paragraphs .22 through .30. This statement of position does

* See also FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, June 1982.

not apply to title insurance. The division's conclusions on accounting for title insurance are presently being considered by the AICPA's Insurance Companies Committee *. Paragraphs .06 through .43 of this statement of position do not apply to mortgage guaranty insurance. The issues discussed in those paragraphs, as they relate to mortgage guaranty insurance, are also presently being considered by the insurance companies committee.

.04 The division's conclusions set forth in this statement of position apply to financial statements of all property and liability insurance companies that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Those companies include, but are not limited to, stock companies, mutual companies, and reciprocal exchanges or inter-insurance exchanges.

.05 The interests of policyholders and the public in the financial integrity of the property and liability insurance companies makes it important that the solvency of those companies be continuously demonstrated to regulatory authorities. Consideration of those interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (statutory accounting practices).¹ Federal income taxation of

* See SOP 80-1 [section 10,300], *Accounting for Title Insurance Companies*. See also FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, June 1982, and FASB Statement No. 61, *Accounting for Title Plant*, June 1982.

¹ Such practices have been prescribed by statute, regulation, or rule or have been permitted by specific approval or acceptance.

property and liability insurance companies is also based primarily on statutory accounting practices. The use of generally accepted accounting principles, as discussed in this statement of position, should not be construed as an indication that those accounting principles should also be used in reporting to regulatory or taxing authorities.

PREMIUM REVENUE RECOGNITION

Discussion

.06 Premiums are generally collected as of the inception of the contract or installment period. Under statutory accounting practices, the premiums are recognized in income evenly over the contract period, generally determined on a monthly or daily basis. That method, which was endorsed by the guide and has been generally accepted in the property and liability insurance industry, usually produces a proper association of premium revenue with losses and expenses that will be incurred over the contract period. However, some believe that a modification should be made to that basis of recognition if (a) the period of risk differs significantly from the contract period or (b) the incidence of risk, or the amount at risk, varies significantly during the contract period.

.07 For the typical policy, the premium is fixed for the period of the contract. In most cases, the fixed amount is recognized over the contract period. However, for retrospectively rated and reporting-form policies, an estimated or deposit premium is collected which is adjusted at a subsequent date, based on experience. In some cases, the deposit premium serves as a means of financing and, therefore, may only be a portion of the estimated premium. Under statutory accounting practices, those premiums are usually accounted for in the following manner: (a) the original estimated or deposit premium is recognized evenly over the contract period with subsequent adjustments charged or credited to income as they occur, or (b) the ultimate premium is estimated, revised during the contract period to reflect current experience, and recognized evenly over the contract period. The guide is silent on that subject and practice varies.

Conclusions

.08 In the insurance industry, the service provided is coverage; therefore, revenue should be recognized as that coverage

is provided. The incidence of *losses* is not relevant to the recognition of revenue but is relevant to the recognition of costs, which should be recognized as losses are incurred.

.09 In most instances, premiums should be recognized as being earned evenly over the term of the insurance contract determined on a monthly or daily basis as the coverage is provided. In those few instances in which the period of risk varies significantly from the contract term, the premium should be recognized evenly over the period of risk. Also, in those few instances in which the amount of coverage declines according to a predetermined schedule, the premium should be recognized in proportion to the amount of coverage.

.10 Premium adjustments (for example, adjustments on retrospectively rated and reporting-form policies) should be accounted for on the accrual basis using an estimate of the ultimate premium. The estimated ultimate premium should be revised to reflect current experience. In those rare situations in which the ultimate premium cannot be reasonably estimated, the accrual basis should not be used.

DEFERRED ACQUISITION COSTS

Discussion

.11 The guide discusses the accounting for costs incurred in connection with writing insurance and obtaining insurance premiums. The guide indicates that statutory accounting practices, which require those costs to be charged to income as they are incurred, do not produce a proper association of costs and revenue. Therefore, the guide suggests that those costs be deferred and amortized over the contract period. That method has gained general acceptance in the industry.

.12 The guide provides little guidance on the types of acquisition costs to be deferred. As a result, the guide has been subject to differing interpretations that have resulted in variations in practices. The principal interpretations of the guide are as follows:

- a. Only those costs that vary directly with and are directly related to the production of business (new and renewal premiums written) should be deferred.
- b. In addition to costs that vary directly, certain costs that vary indirectly and are directly related to the production of business should be deferred.

c. All costs related to the production of business should be deferred.

.13 The guide describes only one method for estimating deferred acquisition costs referred to as "equity in unearned premiums." Some suggest that the method can distort net income if the relationship of costs incurred to premiums written varies significantly from period to period. If deferred acquisition costs are estimated based on a percentage relationship of costs incurred to written premiums, they suggest that the percentage relationship once determined, except for any adjustment related to recoverability (that is, premium deficiency as that item is described in paragraphs .17 and .18), should continue to be applied to the applicable unearned premiums throughout the term of the policies. Furthermore, they suggest that acquisition costs should be amortized using more precise methods such as those used for amortizing unearned premiums in order to associate more properly those costs with premium revenue.

Conclusions

.14 Costs that vary with and are directly related to the production of business (new and renewal premiums written during an accounting period) should be deferred and amortized to income as the related written premiums are earned. Certain expenses, such as commissions and premium taxes, vary directly with and are directly related to the production of new business and can be associated directly with specific revenue. Other expenses, such as salaries of certain employees involved in underwriting and policy issuance functions, inspection report fees, and fees paid to boards and bureaus, may vary indirectly with the production of business but are directly related to the premiums written during the period in which the costs are incurred. Those costs meet the criteria for deferral and association with the related premiums as they are earned. Certain other costs incurred during the period, such as depreciation, collection expenses and uncollectible accounts, professional fees, and general administrative expenses, do not vary directly with and are not directly related to the production of business and therefore should be expensed as incurred.

.15 To apply those expense recognition principles, costs should be analyzed to determine whether they can be asso-

ciated with revenue. Arbitrary percentage allocations of expense classifications do not meet those criteria and therefore should not be used.

.16 Acquisition costs should be deferred and amortized using methods such as those used for amortizing unearned premiums in order to associate more properly those costs with premium revenue. The calculations should be made by reasonable groupings of business consistent with the company's manner of acquiring, servicing, and measuring the profitability of its insurance products. If deferred acquisition costs are calculated based on a percentage relationship of costs incurred to written premiums for a specified period of time, the percentage relationship and the time period used, once determined, should be applied to the applicable unearned premiums throughout the term of the policies, except for adjustments related to premium deficiencies.

PREMIUM DEFICIENCIES

Discussion

.17 The guide states that “. . . since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term. . . .” In addition, the guide suggests that the premium should be adequate to recover any unamortized deferred acquisition costs. Paragraph 96 of FASB Statement no. 5 indicates that “. . . this Statement does not prohibit (and, in fact, requires) accrual of a *net* loss (that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated. . . .”

.18 The guide does not use the term “premium deficiencies” (a term adopted by the division to describe the views of the FASB, which are set forth in paragraph 96 of FASB Statement no. 5). However, with respect to evaluating the recoverability of acquisition costs to be deferred, the guide suggests that consideration be given to (a) the anticipated loss ratio, (b) the anticipated loss expense ratio, and (c) the anticipated ratio of expenses subsequent to acquisition. It further suggests that the determination of those anticipated ratios requires an analysis

of historical data plus knowledge of other factors, such as giving greater weight to the more recent loss experience and taking into account recent rate changes that would be reflected in the unearned premiums in the balance sheet.

.19 *Determination of Premium Deficiencies.* Premium deficiencies are determinable (a) by individual lines of business, (b) by reasonable groupings of business consistent with the company's manner of acquiring, servicing, and measuring profitability of its insurance products, or (c) in the aggregate.

.20 *Anticipated Expenses Subsequent to Acquisition.* As stated above, the guide suggests that anticipated expenses subsequent to acquisition should be considered in evaluating the recoverability of acquisition costs to be deferred. However, the guide provides little guidance regarding what types of expenses subsequent to acquisition should be considered. The guide has been interpreted in various ways as follows:

- a. Only anticipated losses, loss adjustment expenses, and unamortized deferred acquisition costs directly related to policies in force should be considered in determining premium deficiencies.
- b. In addition to anticipated losses, loss adjustment expenses, and unamortized deferred acquisition costs, certain other underwriting expenses (maintenance expenses) should be considered, provided that those costs may be attributed to maintaining the policies in force.
- c. Anticipated loss and loss adjustment expenses, together with all other underwriting expenses, should be considered in determining premium deficiencies.
- d. Anticipated policy dividends should also be considered in the above tests.
- e. Anticipated investment income should also be considered in the above tests.

.21 *Anticipated Investment Income.* The guide states that “. . . since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term. . . .” Furthermore, the guide suggests that the premium should be adequate to recover any unamortized deferred acquisition costs. FASB

Statement no. 5, paragraph 96, requires the accrual of a *net* loss that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated.

.22 The guide is silent on whether investment income should be considered in the calculation of premium deficiencies; FASB Statement no. 5 does not give specific guidance for the calculation of premium deficiencies; current practice has been not to include investment income in the determination of premium deficiencies.

.23 Some believe that the consideration of anticipated investment income in the computation of premium deficiencies is proper for the following reasons:

- a. The concept of establishing premium deficiencies is founded on the generally accepted accounting principle of making provisions for foreseeable losses on contracts currently in force. That concept relates to losses on entire contracts and therefore should include all revenue and expenses relative to those contracts. An integral part of the revenue on insurance contracts is the investment income that will be earned on the funds generated by the collection of premiums in advance of the payment of losses and expenses on those contracts.
- b. The concept of accruing for loss contracts, that is, premium deficiencies, differs from discounting of loss reserves in that the premium deficiency calculation relates to the estimation of future revenue and expenses relative to particular loss contracts, while the concept of discounting loss reserves relates to a currently established liability for losses incurred. Furthermore, the inclusion of investment income is a recognition of interest that will be earned on contract funds that have been collected, while the discounting of loss reserves recognizes the time value of money that relates to funds that may be in excess of the actual funds available for investment on particular loss contracts. Hence, the investment income in the premium deficiency calculation relates to actual funds available for investment, while the discounting concept imputes investment income on funds that may not necessarily have been generated by those particular contracts.
- c. The incidence of recognition of investment income related to unprofitable contracts should be different from the incidence of recognition of investment income related to profitable contracts because of the nature of the contracts. The invest-

ment income on profitable contracts should be recognized as earned following the generally accepted accounting principle of not anticipating gains. However, the investment income relative to loss contracts should be used in determining the “net” loss relative to those contracts in accordance with the generally accepted accounting principle of recognizing *net* losses on unprofitable contracts. As the concept of loss recognition pertains to a “net” loss, it is contemplated that the calculation should include accrual of all anticipated costs and all anticipated revenue relative to those contracts.

.24 Others believe that anticipated investment income should be considered in the calculation of premium deficiencies for the above reasons, but that it would be inconsistent to recognize that investment income and not discount loss reserves. They believe that the recognition of the time value of money results in financial statements that are more in accord with economic reality but cannot support recognizing the effects of anticipated investment income only in the case of premium deficiencies (see paragraphs .34 through .38, “Recognition of the Time Value of Money”). They further believe that to do so would create an unnecessary difference in the application of the matching concept to profitable and unprofitable contracts. Furthermore, they point out that the methodology involved in using investment income in the computation of premium deficiencies is very similar to discounting loss reserves, and, if loss reserves were discounted, the question of using investment income in the computation of premium deficiencies would be moot.

.25 Some believe that anticipated investment income should not be considered in the calculation of premium deficiencies for the following reasons:

- a. FASB Statement no. 5 defines a net loss, which the division describes as a premium deficiency, as “a loss in excess of deferred premiums.” They believe that the term “deferred premiums” is intended to mean “unearned premiums” as commonly used in the insurance industry. In expanding on that view, the guide further indicates that a premium should also be adequate to recover deferred acquisition costs and expenses subsequent to acquisition. The losses and expenses referred to do not suggest that losses and expenses should be estimated any differently for that purpose than for financial statement presentation. Thus, they believe the term

needs no further clarification and indicates no intention on the part of the FASB to consider investment income as a source of revenue in determining a net loss.

- b. Furthermore, they believe that including investment income in the computation of premium deficiencies is not otherwise supported by current generally accepted accounting principles applicable to the determination of asset values. In testing the recoverability of asset values, they believe it may be proper to consider income *directly attributable* to that asset during the recovery period. In those cases, the income considered can be identified as being directly related to the asset being evaluated. In this situation, the asset being tested for recoverability is a deferred charge, which does not and could not generate income. The investable funds generated by the related unearned premiums cannot be segregated and identified with specific contracts. Even if a segregation were possible, they suggest one might find that contracts that are evidencing possible future deficiency problems have already consumed more funds in paying losses to date than they generated in total.

.26 *Financial Statement Presentation.* Some believe that, except in rare instances, future net losses cannot be estimated any more reasonably than catastrophes. Therefore, they believe that the provisions of the guide and FASB Statement no. 5 have little, if any, applicability in practice in this area. Others believe that, while future net losses may not be as reasonably estimable as liabilities for incurred losses, they can be estimated with sufficient reliability to determine whether there will be a net loss on the contract. Therefore, to comply with the guide and the requirements of FASB Statement no. 5, they suggest the following methods to provide for premium deficiencies:

- a. A premium deficiency should first be recognized by writing off any unamortized deferred acquisition costs to the extent required. Should the premium deficiency be greater than the unamortized deferred acquisition costs, loss reserves should be provided for an additional deficiency. This method recognizes that an asset has been impaired and that the impairment should be recognized before any additional liabilities are recorded.
- b. Additional loss reserves should be provided for the full amount of the premium deficiency with no adjustment to

deferred acquisition costs. This method is supported by the view that the original premium contemplated the acquisition costs and that the deficiency is caused by losses in excess of those anticipated at the time premiums were established.

- c. Unearned premiums should be increased by the amount of a premium deficiency. This method is supported by the view that the premium deficiency cannot be attributed to either the acquisition costs or additional losses.

Conclusions

.27 *Determination of Premium Deficiencies.* Premium deficiencies should be determined by reasonable groupings of business consistent with a company's manner of acquiring, servicing, and measuring the profitability of its insurance products.

.28 *Anticipated Expenses Subsequent to Acquisition.* In those instances in which expected losses and loss adjustment expenses, maintenance expenses, policyholder dividends, and unamortized deferred acquisition costs exceed the related unearned premiums, a provision for the anticipated premium deficiency should be provided (in accordance with FASB Statement no. 5, paragraph 96).

.29 Expected losses and loss adjustment expenses, expected policyholder dividends, and unamortized deferred acquisition costs should be considered in determining premium deficiencies. In addition, certain other underwriting expenses (maintenance expenses) should also be considered, provided those costs can be attributed to maintaining the policies in force.

.30 *Anticipated Investment Income.* Although this statement of position discusses the issue of whether anticipated investment income should be considered in computing premium deficiencies, no conclusion has been reached. Because of the importance of that issue, the division believes that it should expose for public comment its conclusions on the issue in a separate statement of position. Until the issue is resolved, companies that consider anticipated investment income in computing premium deficiencies should disclose that fact in their note on accounting policies together with the effects on the financial statements.

.31 *Financial Statement Presentation.* A premium deficiency should first be recognized by writing off any unamortized deferred acquisition costs to the extent required. Should the premium deficiency be greater than the unamortized deferred

acquisition costs, a separate liability should be provided for the excess deficiency. That method recognizes that an asset has been impaired and that the impairment should be recorded before any additional liabilities are recorded.

LOSSES

Discussion

.32 *Basis of Recognition.* Under statutory accounting practices, losses are recognized as incurred. Estimated liabilities are established for losses that have been reported, and additional estimates are made for losses that have been incurred but have not yet been reported to the company. That accounting method was endorsed by the guide, has been generally accepted by industry, and is reaffirmed in FASB Statement no. 5. For losses that are historically settled over a period of years, the estimates generally include the effects of inflation and other social and economic factors on the ultimate dollar cost of settlement; the effects are generally measured using information based on historical and reasonably foreseeable events and trends.

.33 *Salvage and Subrogation.* Regulatory authorities generally do not permit recognition of estimated amounts of salvage and subrogation recoverable on paid and unpaid losses. The guide is silent on that subject and practice varies.

.34 *Recognition of the Time Value of Money.* Some regulatory authorities permit liabilities for losses to be determined based on the present value of future payments for those types of losses that are payable in fixed installments over a long period of time, such as certain workers' compensation and disability insurance claims. Discounting of loss reserves, or the recognition of the time value of money, for other types of claims not expected to be settled in one year is generally not permitted. Under generally accepted accounting principles, losses are generally recorded following statutory accounting practices. The guide is silent on that subject and practice varies.

.35 Those who believe that liabilities for losses and loss adjustment expenses should be stated at their present value suggest that investment income, excluding investment income attributable to stockholders' (members') equity, is an inextricable part of insurance operations, and present value concepts should be applied to all liabilities that are not expected to be settled in one year, provided that the period for settling the losses can be

reasonably estimated. In support of that viewpoint, they cite the fact that at least fifteen states are now taking investment income into consideration in determining premium rates. They believe that further support comes from a review of the economic history of the insurance industry over the last fifty years in which investment income exceeded \$29 billion (excluding investment gains of \$5 billion), while underwriting losses aggregated slightly in excess of \$2 billion over the same period. From that perspective, they believe it is undeniable that if the insurance industry had to depend solely on premium revenue to cover claim costs, acquisition costs, and underwriting expenses, it simply would not survive.

.36 Some believe that all liabilities for losses and loss adjustment expenses not expected to be settled in one year should be stated at their present value. Those who support that view believe that—

- a. Recognition of the time value of money results in financial statements that are more in accord with economic reality than is the case without discounting. The economic history of the insurance industry and the present environment demonstrate that investment income and underwriting results are interrelated.
- b. Valuing loss reserves at their present value is consistent with the generally accepted accounting principle of matching related revenue and expenses. Premium revenue would be matched against the estimated present value of claims incurred, while investment income would be matched against the interest added to the reserves. If losses are not discounted, premium revenue is matched against the estimated total amount to be paid on claims incurred, while investment income has no offset.
- c. Anticipated investment income plays a significant role in determining premium rates. Premiums on lines of business in which losses are settled in a relatively short period of time are generally higher in relation to anticipated losses than premiums on lines of business in which a substantial portion of the losses are settled over a period of years.
- d. Current insurance accounting principles are inconsistent, inasmuch as reserves on life, annuity, and disability policies issued by life insurance companies are discounted, while

long-term reserves of property and liability insurance companies are not.

- e. Although the use of present values involves estimates of the timing of future payments, the estimates would be based on historical experience modified for current trends. The use of discounted loss reserves should not imply greater precision than gross dollar reserves because all elements of the loss reserve (gross dollar value, salvage and subrogation recoverable, and payment pattern) are estimates.

.37 Those who support discounting, or the recognition of the time value of money, believe that the issue is so significant to the determination of financial position, results of operations, and changes in financial position of property and liability insurance companies that financial statements will continue to be interpreted differently until the issue is resolved.

.38 Others believe that present value concepts should be applied only to those types of losses that are payable in fixed installments over a long period of time, such as workers' compensation and other forms of disability insurance. Those who support this view believe that—

- a. Those liabilities are contractual obligations to pay money on fixed or determinable dates as contemplated in APB Opinion 21, *Interest on Receivables and Payables*.
- b. Present value concepts should be applied only to those types of losses because the application of present value concepts to other types of losses involve estimates of both the amounts and the timing of payments, and there is too much subjectivity inherent in establishing estimates of losses that will not be paid until some undetermined future date to permit those losses to be stated at their present value. To do so would imply a greater degree of precision than is warranted.

Conclusions

.39 *Basis of Recognition.* Under generally accepted accounting principles, losses should be recognized in the financial statements as incurred, including estimates for incurred but not reported losses. Provisions for unpaid losses should be based on the best estimate of the ultimate cost of settlement (including the effects of inflation and other social and economic factors), reduced by estimated salvage and subrogation recoveries, using past experience adjusted for current trends and any other factors

that would modify past experience. Changes in loss estimates resulting from the continuous review process and differences between estimates and ultimate payments should be reflected in income of the period in which the estimates are changed.

.40 *Salvage and Subrogation.* Estimated amounts of salvage and subrogation recoverable on paid and unpaid losses should be recorded as a reduction of unpaid losses with disclosure of the amounts deducted.²

.41 *Recognition of the Time Value of Money.* Although this statement of position discusses the issue of whether loss reserves should be discounted, that is, whether the time value of money should be considered in determining loss reserves, no conclusion has been reached. Because of the importance of that issue, the division believes that it should expose for public comment its conclusions on the issue in a separate statement of position. Until the issue is resolved, companies that discount loss reserves or loss adjustment expenses³ should disclose that fact in their note on accounting policies together with the effects on the financial statements.

LOSS ADJUSTMENT EXPENSES

Discussion

.42 Statutory accounting practices require that all costs associated with the settlement of losses be accrued in the period that the related losses are incurred. Those costs include amounts paid for outside services and direct, indirect, and fixed internal costs associated with the settlement of claims. No exception to that practice was presented in the guide, and the practice has been accepted in industry.

Conclusions

.43 All expenses expected to be incurred in connection with the settlement of unpaid losses should be accrued. Certain of those expenses, such as legal and adjusters' fees, can be associated directly with specific losses paid or in the process of settlement. Other of those expenses, such as the internal costs of the

² The insurance companies committee has noted that this accounting practice appears to be uniform; accordingly, disclosure of the estimated amount of salvage and subrogation is considered adequate, rather than presenting the estimated amount as an asset.

³ See paragraphs .42 and .43.

claims function, cannot be associated with specific losses but are related to losses paid or in the process of settlement.⁴

REINSURANCE

Discussion

.44 Under statutory accounting practices, amounts recoverable from reinsurers related to paid losses are classified as an asset, whereas amounts recoverable on unpaid losses and for ceded unearned premiums are offset against the related liability accounts. The guide is silent on that subject, and the practice is generally accepted in the industry. However, some believe that all amounts recoverable from reinsurers should be classified as assets, subject to appropriate valuation allowances, rather than as offsets to liability accounts on the basis that generally accepted accounting principles do not permit offsetting receivables and payables to unrelated parties.

.45 Those who support the statutory accounting practice believe that reinsurance is inextricably linked to the basic policy transaction. For example, if the amount of commercial fire coverage required exceeds the retention limit of any one company, the several companies insuring the risk could either issue separate policies for their portion of the risk or one company could issue a single policy for the total coverage and reinsure the coverage in excess of its retention limit. In either case, the net financial statement result is the same and form should not prevail over substance.

.46 Under statutory accounting practices, reinsurance premiums ceded are reported as a reduction of written and earned premiums. The guide is silent on that subject and the practice is generally accepted in the industry. Some believe the purchase of catastrophe insurance coverage by a company is not a true sharing of risk and, therefore, the premiums should be treated as operating expenses as opposed to a reduction in written and earned premiums. Those who support the statutory accounting practice believe, as stated above, that reinsurance is inextricably linked to the basic policy transaction and that a distinction cannot be made between a sharing of risk and the purchase of insurance.

⁴ See paragraph .41.

Conclusions

.47 Amounts recoverable from reinsurers that are related to paid losses and loss adjustment expenses, if applicable, should be classified in the financial statements as assets, subject to appropriate valuation allowances. Estimated amounts recoverable from reinsurers that are related to unpaid losses and loss adjustment expenses should be deducted from the unpaid losses and loss adjustment expenses with disclosure of the amounts deducted.⁵ Ceded unearned premiums do not represent receivables; therefore, those amounts should be netted against the related unearned premiums. Receivables and payables from the same reinsurer, including funds withheld, should be offset. Reinsurance premiums ceded and reinsurance recoveries on losses may be netted against the respective earned premiums and incurred losses in the income statement.

.48 Companies should disclose (a) the nature of their reinsurance activities, (b) reinsurance premiums assumed and ceded that are included in or deducted from earned premiums (disclosure should also be made on a written premium basis if the difference is material), and (c) premiums and recoveries on catastrophe type reinsurance contracts deducted from premiums earned and losses incurred, respectively.

POLICYHOLDER DIVIDENDS AND CONTINGENT COMMISSIONS

Discussion

- .49 Under statutory accounting practices—
- a. Policyholder dividends are generally recorded as liabilities when declared by the board of directors.
 - b. Contingent commissions are recognized in financial statements on either the accrual basis, a modified cash basis (that is, accrual for commissions on expired contracts), or the cash basis.

Conclusions

.50 Generally accepted accounting principles require the use of accrual basis accounting; therefore—

⁵ The insurance companies committee has noted that this accounting practice appears to be uniform; accordingly, disclosure of the estimated amount of reinsurance is adequate, rather than presenting the estimated amount as an asset.

- a. Dividends should be accrued using best estimates of the amounts to be paid.
- b. Contingent commissions receivable or payable should be accrued over the period during which the related profits are recognized.

VALUATION OF INVESTMENTS AND RECOGNITION OF RELATED REALIZED AND UNREALIZED GAINS OR LOSSES

Discussion

.51 Under statutory accounting practices, investments in common and preferred stocks are carried at market value, bonds are generally carried at amortized cost, mortgages are generally carried at unpaid principal, and real estate generally is carried at depreciated cost. Realized investment gains or losses are credited or charged to income. Changes in the carrying amount of investments representing unrealized appreciation or depreciation are charged or credited to stockholders' (members') equity.

.52 The statutory method of accounting for investments is supported by the following reasoning—

- a. Carrying bonds whose value has not been permanently impaired at amortized cost is appropriate since a company that has the ability and intent to hold the investments to maturity will be able to realize face amount. Market values that reflect periodic changes in prevailing interest rates are irrelevant in valuing bonds that are expected to be held to maturity.
- b. Carrying common and preferred stocks at market is appropriate because a company has no assurance that it will receive more or less than the current market value.
- c. Including realized investment gains and losses in net income is appropriate since it is based on the realization principle. Periodic fluctuations in market value are appropriately recognized in valuing equity investments but should not be included in net income because the fluctuations do not meet the realization principle.

.53 The guide endorses the statutory basis for valuing investments. However, it suggests that realized and unrealized investment gains or losses should be combined in a separate financial statement. Those who support the separate statement approach believe that valuation of investments under the statutory method

is appropriate for the reasons stated above. However, they advocate that changes in the value of investments, whether realized or unrealized, should be presented in a separate financial statement as one combined amount. They believe that the treatment is the most meaningful since the realization of a gain or loss has an offsetting effect on the related unrealized gain or loss. Because of the materiality of the amounts and the significant fluctuations that occur, realized and unrealized gains or losses should not be included in the determination of net income because they feel they would make net income meaningless.

.54 Some believe that the results of realized gains and losses should be reported as an integral part of an insurance company's results of operations because an investor's appraisal of an insurance company's performance should include the results of realized gains and losses over a period of years.

.55 FASB Statement no. 12, *Accounting for Certain Marketable Securities*, discusses the accounting treatment to be followed by specialized industries, such as property and liability insurance companies, with respect to investments in common and preferred stocks.

Conclusions

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

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

.58 Mortgages should be accounted for at unpaid principal unless collectibility is uncertain. Real estate investments should be accounted for at depreciated cost unless there is an impairment in value. Amortization, depreciation, and other related charges or credits should be charged or credited to investment

income. Charges and credits to valuation accounts should be included in realized gains and losses.

.59 Realized gains and losses on all assets held for investment (including, but not limited to, stocks, bonds, mortgage loans, real estate, joint ventures, and subsidiaries held for investment) should be included in the statement of income, below operating income and net of applicable income taxes. Realized gains and losses on the sale of other assets, such as property used in the business and operating subsidiaries, should be included in the statement of income before applicable income taxes. Unrealized investment gains and losses should be recognized in stockholders' (members') equity net of applicable income taxes.

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

.61 Valuation accounts are not appropriate for bonds, common stocks, or preferred stocks.

REAL ESTATE

Discussion

.62 Under statutory accounting practices, real estate is classified as an investment regardless of its use. For real estate used in operations, rent is included in investment income and is charged to the operating departments. The guide is silent on that subject, and the statutory accounting practice has gained general acceptance in the industry.

Conclusions

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

ACCIDENT AND HEALTH INSURANCE

Discussion

.64 Accident and health insurance contracts are issued by both property and liability insurance companies and life insurance companies. Currently, those companies may account for their accident and health insurance contracts differently depending on which audit guide the companies follow.

Conclusions

.65 The accounting for accident and health insurance contracts should be the same irrespective of the company issuing the contracts. The applicable provisions of this statement of position should be applied to short-term accident and health insurance contracts. The provisions of the industry audit guide, *Audits of Stock Life Insurance Companies*, should be applied to long-term accident and health insurance contracts. Individual and group contracts that are noncancelable, collectively renewable, or guaranteed renewable should be considered long-term contracts. Contracts that are renewable at the option of the company (cancelable contracts) may also be considered long term if it can be demonstrated that they are likely to remain in force for a reasonable period of time, similar to guaranteed renewable contracts. All other contracts should be accounted for as short-term contracts.

TRANSITION

.66 The conclusions in this statement of position should be applied to financial statements of property and liability insurance companies issued for annual and interim periods beginning after December 31, 1978. Earlier application is encouraged. The conclusions in this statement of position should be applied retroactively, and financial statements presented for prior periods should be restated. The individual effects of changing to the accounting principles in this statement of position should be disclosed in the financial statements.

ACCOUNTING STANDARDS DIVISION

Accounting Standards Executive Committee

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Section 10,220

***Statement of Position 78-7
Financial Accounting and Reporting
by Hospitals Operated by
a Governmental Unit***

[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

July 31, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

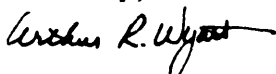
Dear Mr. Kirk:

The accompanying statement of position, Financial Accounting and Reporting by Hospitals Operated by a Governmental Unit, has been prepared by the accounting standards division.

The statement is an amendment of the AICPA Industry Audit Guide, Audits of State and Local Governmental Units, issued in 1974 and presents the division's recommendation for the accounting and reporting by hospitals operated by a governmental unit.

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

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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.

FINANCIAL ACCOUNTING AND REPORTING
BY HOSPITALS OPERATED BY A
GOVERNMENTAL UNIT

.01 The AICPA Industry Audit Guide, *Hospital Audit Guide*, does not specifically address the financial accounting and reporting practices of hospitals that are operated by a governmental unit but states that the practices it discusses apply to all hospitals. The AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*, effectively includes government operated hospitals within its scope. That overlap has raised questions concerning the financial accounting and reporting practices that should be followed by hospitals operated by governmental units.

.02 Different views exist about whether the financial activities of a hospital operated by a governmental unit should be accounted for as an enterprise fund or as a special revenue fund. Hospitals accounted for as enterprise funds usually follow practices comparable to those discussed in the *Hospital Audit Guide*, and hospitals accounted for as special revenue funds follow the practices discussed in *Audits of State and Local Governmental Units*. Since these accounting practices differ significantly, the accounting standards division believes that *Audits of State and Local Governmental Units* should be amended to provide for uniformity in the financial reporting of hospitals.

THE DIVISION'S CONCLUSION

.03 Some government operated hospitals have been accounted for as special revenue funds and others as enterprise funds, depending on the source of funding. The accounting standards division believes, however, that the source of revenues should not determine the accounting practices followed by hospitals. If all government operated hospitals followed the *Hospital Audit Guide* and were accounted for as enterprise funds, more comparable financial statements within the hospital industry would result. The division therefore believes that *Audits of State and Local Governmental Units* should be amended by the addition of the following paragraph (and its accompanying footnote) as the first full paragraph on page 14 of the guide.

Hospitals that are operated by governmental units should follow the requirements of the AICPA's *Hospital Audit Guide*. Since the accounting recommended in that guide can best be accommodated in the enterprise funds, such funds should be used in accounting for governmental hospitals.*

* See page 1 of the *Hospital Audit Guide* for a discussion of the types of hospitals covered.

TRANSITION

.04 This statement should be applied for fiscal years beginning after June 30, 1979. Earlier application of the statement of position is encouraged. The recommendations should be applied retroactively by prior-period adjustments, that is, reflected as adjustments of opening fund balances of the earliest years presented. When financial statements for periods before June 30, 1979, are presented, they should be restated to reflect the prior-period adjustments. The nature of the restatements and their effects should be disclosed in the period of change.

ACCOUNTING STANDARDS DIVISION

Accounting Standards Executive Committee

Arthur R. Wyatt, <i>Chairman</i>	Lavern O. Johnson
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Task Force on Municipal Hospitals

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Paul Rosenfield, <i>Director</i> <i>Accounting Standards</i>	Gabriel V. Carifi, <i>Manager</i> <i>Accounting Standards</i>
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Section 10,240**Statement of Position 78-9
Accounting for Investments in
Real Estate Ventures*****[Proposal to Financial Accounting Standards Board]****AICPA****American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 29, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

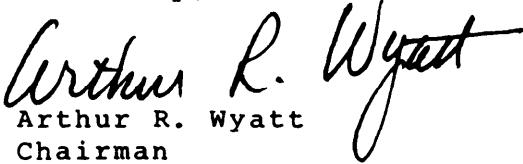
The accompanying statement of position, Accounting for Investments in Real Estate Ventures, has been prepared on behalf of the division by the AICPA Committee on Real Estate Accounting and approved by the AICPA Accounting Standards Executive Committee.

The statement presents the division's recommendations on accounting for investments in real estate ventures (corporate joint ventures, general and limited partnerships, and undivided interests). The recommendations are primarily an application of the existing authoritative accounting literature to the specialized accounting problems related to such investments and are intended to narrow the range of alternative practices.

* See also FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, June 1982.

Representatives of the division are available to discuss this proposal with you or your staff at your convenience.

Sincerely,

A handwritten signature in black ink that reads "Arthur R. Wyatt". The signature is written in a cursive style with a large, sweeping "W" and "Y".

Arthur R. Wyatt
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTE

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of positions do not establish standards enforceable under the Institute's code of professional ethics.

ACCOUNTING FOR INVESTMENTS IN REAL ESTATE VENTURES *

INTRODUCTION

.01 Ownership of real estate or real estate development projects by two or more entities may take several forms. The most common forms are as follows:

- a. *A corporate joint venture*—a corporation owned and operated by a small group of ventures to accomplish a mutually beneficial venture or project, as described in paragraph 3 of APB Opinion 18.
- b. *A general partnership*—an association in which each partner has unlimited liability.
- c. *A limited partnership*—an association in which one or more general partners have unlimited liability and one or more partners have limited liability. A limited partnership is usually managed by the general partner or partners, subject to limitations, if any, imposed by the partnership agreement.
- d. *An undivided interest*—an ownership arrangement in which two or more parties jointly own property, and title is held individually to the extent of each party's interest.

In this statement of position, the terms *real estate venture* and *venture* apply to all of the ownership arrangements described in this paragraph.

.02 These forms of ownership differ in legal form and economic substance, and the authoritative accounting literature dealing with the specialized accounting problems related to

* See also FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, June 1982.

such investments is limited. In practice, those accounting problems are dealt with in a variety of ways, and the division believes narrowing the range of those alternative practices is desirable.

.03 This statement of position presents the division's recommendations on accounting for investments in real estate ventures in financial statements prepared in conformity with generally accepted accounting principles. It does not apply to regulated investment companies and other entities that are required to account for investments at quoted market value or fair value.

THE APPLICABILITY OF THE EQUITY METHOD OF ACCOUNTING

Corporate Joint Ventures

.04 APB Opinion 18 requires investments in corporate joint ventures to be accounted for by the equity method and includes guidance for applying that method in the financial statements of the investor. That opinion applies to corporate joint ventures created to own or operate real estate projects.

.05 Paragraph 3 of APB Opinion 18 states that "an entity which is a subsidiary of one of the 'joint venturers' is not a corporate joint venture." A subsidiary, according to that opinion, refers to

... a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50 percent) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

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

General Partnerships

.06 The staff of the American Institute of Certified Public Accountants issued an interpretation of APB Opinion 18 in November, 1971, which concludes that many of the provisions

of APB Opinion 18 are appropriate in accounting for investments in certain unincorporated entities. The division believes that the principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume joint and several liability. The division believes, however, that the equity method enables noncontrolling investors in general partnerships to reflect the underlying nature of their investments in those ventures as well as it does for investors in corporate joint ventures. Accordingly, the division believes that investments in noncontrolled real estate general partnerships should be accounted for and reported under the equity method. This recommendation requires the one-line equity method of presentation in both the balance sheet and the statement of income.¹ Paragraph 19 of APB Opinion 18 should be used as a guide in applying the equity method. Investors in general partnerships should provide for income taxes on the profits accrued on their investment in the partnership regardless of the tax basis used in the partnership return. The tax liabilities applicable to partnership interests relate directly to the partners, and the accounting for income taxes generally contemplated by APB Opinion 11 is appropriate. Thus, the differences, if any, between income or loss recorded by a partner under the equity method and the partner's share of distributable taxable income or loss from the partnership should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

.07 The division believes a general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. APB Opinion 18 states that the usual condition for control of a corporation is ownership of a majority (over 50 percent) of the outstanding voting stock. However, if partnership voting interests are not clearly indicated, a condition that would usually indicate control is ownership of a majority (over 50 percent) of the financial interests in profits or losses (see paragraph .25). The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other partners, or by court decree. On the other hand, majority ownership may not constitute control if major decisions such as the acquisition, sale, or

¹ Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph .11.

refinancing of principal partnership assets must be approved by one or more of the other partners. The division believes that a controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries. Accordingly, intercompany profits and losses on assets remaining within the group should be eliminated. A noncontrolling investor in a general partnership should account for its investment by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18.

Limited Partnerships

.08 The division believes that the accounting recommendations for use of the equity method of accounting for investments in general partnerships are generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner's interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate. Under the cost method, income recognized by the investor is limited to distributions received, except that distributions that exceed the investor's share of earnings after the date of the investment are applied to reduce the carrying value of the investment. Also, differences between income or losses recognized for financial reporting purposes and the investor's share of taxable income or losses should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

.09 The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be deemed to have the controlling interest in a limited partnership. However, if limited partners have important rights, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. The division believes that the general partners are in control and should account for their investments in accord-

ance with the recommendations in paragraph .07 only if the substance of the partnership or other agreements provides for control by the general partners.

.10 The division believes that if the substance of the partnership arrangement is such that the general partners are not in control of the major operating and financial policies of the partnership, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest. A controlling limited partner should be guided in accounting for its investment by the principles for investments in subsidiaries. Noncontrolling limited partners should account for their investments by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18, as discussed in paragraphs .06 and .07, or by the cost method, as discussed in paragraph .08, as appropriate.

Undivided Interests

.11 In an interpretation of APB Opinion 18 issued by the staff of the American Institute of Certified Public Accountants in November, 1971, the staff concluded that most of the provisions of paragraph 19 of APB Opinion 18 generally would be appropriate in accounting for partnerships and unincorporated ventures, but that if

. . . the investor-venturer owns an undivided interest in each asset and is proportionately (i. e., severally) liable for its share of each liability, the provisions of the equity method set forth in paragraph 19(c) of the Opinion may not apply in some industries. For example, where it is the established industry practice . . . , the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

If real property owned by undivided interests is subject to joint control by the owners, the division believes that investor-venturers should not present their investments by accounting for their pro rata share of the assets, liabilities, revenues, and expenses of the ventures. Such property is subject to joint control if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners. Most real estate ventures with ownership in the form of undivided interests are subject to some level of joint control. Accordingly, the division believes that such investments should be presented in the same manner as investments in noncontrolled

partnerships. If, however, the approval of two or more of the owners is not required for decisions regarding the financing, development, sale, or operations of real estate owned and each investor is entitled to only its pro rata share of income, is responsible to pay only its pro rata share of expenses, and is severally liable only for indebtedness it incurs in connection with its interest in the property, the investment may be presented by recording the undivided interest in the assets, liabilities, revenue, and expenses of the venture.

GENERAL MATTERS

Disclosure

.12 The division believes that investors in real estate ventures should be guided by the provisions of paragraph 20 of APB Opinion 18 in determining the disclosures to be made in their financial statements.

Statement of Changes in Financial Position

.13 APB Opinion 19, which governs the form and content of statements of changes in financial position, requires disclosure of working capital or cash provided from operations. The investor's share of a real estate venture's earnings reported under the equity method, to the extent that such earnings are not distributed in the period earned, should not be included in the amount reported as working capital or cash provided by operations, except to the extent distributions should be accrued as a current receivable under generally accepted accounting principles.

INVESTOR ACCOUNTING FOR LOSSES

General

.14 Some investors have suggested that their equity in losses of a real estate venture need not be recorded under the equity method of accounting as long as the value of their investment has not been impaired; for example, if it is expected that the venture's assets can be sold for more than their carrying value. The division believes that investors should record their share of the real estate venture's losses, determined in conformity with generally accepted accounting principles, without regard to unrealized increases in the estimated fair value of the venture's assets.

Accounting for an Investor's Share of Losses in Excess of Its Investment, Including Loans and Advances

.15 The division believes that an investor that is liable for the obligations of the venture or is otherwise committed to provide additional financial support to the venture should record its equity in real estate venture losses in excess of its investment, including loans and advances.² The following are examples of such circumstances:

- a. The investor has a legal obligation as a guarantor or general partner.
- b. The investor has indicated a commitment, based on considerations such as business reputation, intercompany relationships, or credit standing, to provide additional financial support. Such a commitment might be indicated by previous support provided by the investor or statements by the investor to other investors or third parties of the investor's intention to provide support.

.16 An investor in a real estate venture should report its recorded share of losses in excess of its investments, including loans and advances, as a liability in its financial statements.

.17 If an investor does not recognize venture losses in excess of its investment, loans, and advances and the venture subsequently reports net income, the investor should resume applying the equity method only after its share of such net income equals the share of net losses not recognized during the period in which equity accounting was suspended.

.18 If it is probable that one or more investors cannot bear their share of losses, the remaining investors should record their proportionate shares of venture losses otherwise allocable to investors considered unable to bear their share of losses.³ When the venture subsequently reports income, those remaining investors should record their proportionate share of the venture's net income otherwise allocable to investors considered unable to bear their share of losses until such income equals the excess

² An investor, though not liable or otherwise committed to provide additional financial support, should provide for losses in excess of investment when the imminent return to profitable operations by the venture appears to be assured. For example, a material nonrecurring loss of an isolated nature, or start-up losses, may reduce an investment below zero though the underlying profitable pattern of an investee is unimpaired.

³ This recommendation does not apply for real property jointly owned and operated as undivided interests in assets if the claims or liens of the investor's creditors are limited to the investors' respective interests in such property.

losses they previously recorded. The division also believes that an investor who is deemed by other investors to be unable to bear its share of losses should continue to record its contractual share of losses unless it is relieved from the obligation to make payment by agreement or operation of law.

.19 The division believes that the accounting by an investor for losses otherwise allocable to other investors should be governed by the provisions of FASB Statement no. 5 relating to loss contingencies. Accordingly, the investor should record a proportionate share of the losses otherwise allocable to other investors if it is probable that they will not bear their share. In this connection, the division believes that each investor should look primarily to the fair value of the other investors' interests in the venture and the extent to which the venture's debt is nonrecourse in evaluating their ability and willingness to bear their allocable share of losses.⁴ However, there may be satisfactory alternative evidence of an ability and willingness of other investors to bear their allocable share of losses. Such evidence might be, for example, that those investors previously made loans or contributions to support cash deficits, possess satisfactory financial standing (as may be evidenced by satisfactory credit ratings), or have provided adequately collateralized guarantees.

Loss in Value of an Investment, Including Loans and Advances, Other Than a Temporary Decline

.20 A loss in value of an investment, including loans and advances, other than a temporary decline should be recognized under the accounting principles that apply to a loss in value of long-term assets. Such a loss in value may be indicated, for example, by a decision by other investors to cease providing support or reduce their financial commitment to the venture.

OTHER ACCOUNTING MATTERS RELATED TO THE USE OF THE EQUITY METHOD

Eliminating Interentity Profits and Losses

.21 As noted elsewhere in this statement, APB Opinion 18 should be used as a guide when applying the equity method. Paragraph 19(a) of that opinion provides that, in applying the

⁴An investor may not be able to apply the general rule to an investment in an undivided interest because the extent to which the interests of other investors are encumbered by liens may not be known.

equity method, intercompany profits and losses should be eliminated until realized by the investor or investee as if the investee company were consolidated. The division believes that intercompany profit should be eliminated by the investor in relation to the investor's ownership interest in the investee, except that an investor that controls the investee and enters into a transaction with the investee should eliminate all of the intercompany profit on assets remaining within the group.

.22 The AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate* *, sets out similar rules in paragraph 58:

A sale of property in which the seller holds or acquires an equity interest in the buyer should result in recognizing only the part of the profit proportionate to the outside interest in the buyer. No profit should be recognized if the seller controls the buyer . . . until realized from transactions with outside parties through sale or operations of the property.

.23 The division believes that if a transaction with a real estate venture confirms that there has been a loss in the value of the asset sold that is other than temporary and that has not been recognized previously, the loss should be recognized on the books of the transferor.

Accounting Principles Used by the Venture

.24 In the real estate industry, the accounts of a venture may reflect accounting practices, such as those used to prepare tax basis data for investors, that vary from generally accepted accounting principles. If the financial statements of the investor are to be prepared in conformity with generally accepted accounting principles, such variances that are material should be eliminated in applying the equity method.

Allocation Ratios for the Determination of Investor Income

.25 Venture agreements may designate different allocations among the investors of the venture's (a) profits and losses, (b) specified costs and expenses, (c) distributions of cash from operations, and (d) distributions of cash proceeds from liquidation. Such agreements may also provide for changes in the allocations at specified times or on the occurrence of specified

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

events. Accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph .19. The division believes that in order to determine the investor's share of venture net income or loss, such agreements or arrangements should be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with generally accepted accounting principles) will affect cash payments to the investor over the life of the venture and on its liquidation. The division believes that specified profit and loss allocation ratios should not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis. For example, if a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them, there is no substance to the purported allocation of depreciation expense.

Accounting for a Difference Between the Carrying Amount of an Investment in a Real Estate Venture and the Underlying Equity in Net Assets

.26 Differences between the carrying amount of an investment in a real estate venture and the investor's equity in the underlying net assets recorded by the venture may arise, for example, from unrecognized profit on transfers of real estate to the venture or differences in accounting methods. In addition, differences may arise from the acquisition of an investment in a venture at a price different from the investor's share of the net assets as recorded on the books of the venture.

.27 Differences that arise from a business combination with a venture accounted for as a purchase should be accounted for in accordance with the provisions of APB Opinion 16. The division believes that an excess of the cost of the investment acquired over the equity in the underlying net assets usually would be ascribed to the fair values of real property interest owned by the venture. Any cost in excess of amounts assigned to identifiable tangible or intangible assets acquired is an

intangible asset that should be amortized in a systematic manner related to the purpose of the venture. Because of the limited life and limited purpose usually inherent in real estate ventures, the division believes that the benefits from such an intangible asset generally decline as the property is sold or depreciated, and therefore amortization of that intangible asset should be recorded in relation to cost of sales or depreciation. The period of amortization should not, however, exceed forty years.

.28 Paragraph 19(b) of APB Opinion 18 provides that the difference between the cost of an investment and the amount of the underlying equity in net assets of the investee "should affect the determination of the amount of the investor's share of earnings or losses of an investee as if the investee were a consolidated subsidiary." The differences should be recognized by the investor as an adjustment to the amount of the venturer's depreciation, cost of sales, or other expenses, as appropriate, in recording income or loss from the venture on the equity basis.

ACCOUNTING BY THE INVESTOR FOR CERTAIN TRANSACTIONS WITH A REAL ESTATE VENTURE

Capital Contributions

.29 *Contribution of Cash.* If all investors contribute cash at the formation of the real estate venture, each investor should record its investment at the amount of the cash contributed.

.30 *Contribution of Real Estate.* The division believes an investor that contributes real estate to the capital of a real estate venture generally should record its investment in the venture at the investor's cost (less related depreciation and valuation allowances) of the real estate contributed, regardless of whether the other investors contribute cash, property, or services. The division believes that an investor should not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process. The division understands, however, that some transactions, structured in the form of capital contributions, may in economic substance be sales. The recommendations in paragraph .36 of this statement on accounting for sales of real estate to a venture by an investor apply to those transactions.

An example of such a transaction is one in which investor *A* contributes to a venture real estate with a fair value of \$2,000 and investor *B* contributes cash in the amount of \$1,000 which is immediately withdrawn by investor *A*, and, following such contributions and withdrawals, each investor has a 50 percent interest in the venture (the only asset of which is the real estate). Assuming investor *A* is not committed to reinvest the \$1,000 in the venture, the substance of this transaction is a sale by investor *A* of a one-half interest in the real estate in exchange for cash. A minority of the division disagrees with the conclusion that an investor contributing real estate to a real estate venture should record its investment at the cost of the real estate contributed. They believe that profit recognition by such an investor to the extent of the other investors' interests in the profits and losses of the venture may be appropriate if the other investors contribute cash or other hard assets (such as marketable securities) for their interests and the investor contributing the real estate has no continuing involvement with the real estate that would require deferral of profit under the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate* *. The majority of the division believes that unless the investor that contributes real estate to the venture withdraws cash (or other hard assets) and has no commitment to reinvest, such a transaction is not the culmination of an earnings process.

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

.32 *Contribution of Services or Intangibles.* The division believes the accounting considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or intangibles. The investor's cost of such services or intangibles to be allocated to the cost of the investment should be determined by the investor in the same manner as for an investment in a wholly owned real estate project.

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

Income From Loans or Advances to a Venture

.33 Interest on loans and advances that are in substance capital contributions (for example, if all the investors are required to make loans and advances proportionate to their equity interests) should be accounted for as distributions rather than as interest income by the investors.

.34 An investor-lender that does not capitalize interest on its own real estate construction and development projects should account for interest on loans and advances that are not in substance capital contributions in accordance with the recommendations in this paragraph.

- a. All interest income on the investor's loans or advances to the venture should be deferred if either of the following conditions is present.
 - (i) Collectibility of the principal or interest is in doubt. This condition may exist if adequate collateral and other terms normally required by an independent lender are not present.
 - (ii) There is a reasonable expectation that the other investors will not bear their shares of losses, resulting in uncertainty as to the lender's share of the venture's related interest expense.
- b. If neither of the conditions in (a) is present and either the venture has recorded interest as an expense or the venture has capitalized the interest but in order to conform to the investor's accounting policies, the investor has recorded its equity in the income or loss of the venture as if the venture had charged the interest to expense, the entire interest income accrued on loans or advances to a venture should be recorded as earned.
- c. If the conditions in (a) or (b) are not present, a portion of interest income from loans and advances to a venture should be deferred based on the investor's percentage interest in the profits and losses of the venture. However, an evaluation similar to that discussed in paragraphs .18 and .19 for recording the investor's share of losses should be made to avoid recording as interest income amounts that may ultimately be borne as losses by the investor making the loan.

.35 Pending completion of the Financial Accounting Standard Board's interest project, the division makes no recommendation on accounting for interest income from loans or advances to a real estate venture by an investor that capitalizes interest on its own real estate and development projects.

Sales of Real Estate to a Venture

.36 Sales of real estate by an investor to a real estate venture are subject to all of the provisions set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*.*

Sales of Services to a Venture

.37 If services are performed for a venture by an investor and their cost is capitalized by the venture, profit may be recognized by the investor to the extent attributable to the outside interests in the venture if the following conditions are met:

- a. The substance of the transaction does not significantly differ from its form.
- b. There are no substantial uncertainties about the ability of the investor to complete performance (as may be the case if the investor lacks experience in the business of the venture) or the total cost of services to be rendered.
- c. There is a reasonable expectation that the other investors will bear their share of losses, if any.

The method of recognizing income from services rendered should be consistent with the method followed for services performed for unrelated parties.

Purchases of Real Estate or Services From a Venture

.38 An investor should not record as income its equity in the venture's profit from a sale of real estate to that investor; the investor's share of such profit should be recorded as a reduction in the carrying amount of the purchased real estate and recognized as income on a pro rata basis as the real estate is depreciated or when it is sold to a third party. Similarly, if a venture performs services for an investor and the cost of those services is capitalized by the investor, the investor's share of the venture's profit in the transaction should be recorded as a reduction in the carrying amount of the capitalized cost.

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

ACCOUNTING FOR THE SALE OF AN INTEREST IN A REAL ESTATE VENTURE

.39 The division believes that a sale of an investment in a real estate venture (including the sale of stock in a corporate real estate venture) is the equivalent of a sale of an interest in the underlying real estate and should be evaluated under the guidelines set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate* *.

.40 Subject to the provisions of paragraph .39, an investor should recognize a gain or loss on a sale of its investment in a real estate venture equal to the difference at the time of sale between the selling price and the investor's carrying amount of the portion of the investment sold. Deferred taxes related to timing differences should be recognized.

TRANSITION

.41 The division recommends applying this statement of position to financial statements issued for fiscal years and interim periods beginning after December 24, 1978. Adjustments resulting from a change in accounting method to comply with the recommendations in this statement should be applied retroactively, if material, and, to enhance comparability between periods, financial statements presented for the periods affected should be restated for as many periods as is practicable to give retroactive effect to such adjustments and to changes in presentation. The division encourages earlier application of the recommendations in this statement for fiscal years beginning before December 25, 1978, in financial statements not previously issued.

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

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Section 10,250**Statement of Position 78-10
Accounting Principles and Reporting
Practices for Certain Nonprofit
Organizations**

December 31, 1978

[A Proposed Recommendation to the Financial Accounting Standards Board]**NOTE**

Statements of position of the AICPA accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

INTRODUCTION

.001 The American Institute of Certified Public Accountants has issued the following industry audit guides applicable to certain types of nonprofit organizations.*

- *Hospital Audit Guide* (1972)
- *Audits of Colleges and Universities* (1973)
- *Audits of Voluntary Health and Welfare Organizations* (1974)
- *Audits of State and Local Governmental Units* (1974)

* In 1981, the AICPA issued Audit and Accounting Guide, *Audits of Certain Non-profit Organizations*.

.002 However, many nonprofit organizations are not covered by any of those guides. This statement of position is issued to recommend financial accounting principles and reporting practices for nonprofit organizations not covered by existing guides that prepare financial statements in conformity with generally accepted accounting principles. This statement is not intended to supersede or amend any of the listed guides. For numerous nonprofit organizations, complex accounting may be neither practical nor economical, and reporting based on cash receipts and disbursements or some other basis may be adequately informative. Under those circumstances, special-purpose financial reports should be prepared.

.003 The provisions of this statement need not be applied to immaterial items.

.004 A number of terms with specialized meanings are used throughout this statement and are defined in Appendix A.

.005 This statement of position applies to all nonprofit organizations not covered by the AICPA industry audit guides listed in paragraph .001, other than those types of entities that operate essentially as commercial businesses for the direct economic benefit of members or stockholders. Examples of the latter category are employee benefit and pension plans, mutual insurance companies, mutual banks, trusts, and farm cooperatives. Although this list is not all-inclusive, the following organizations are among those covered by this statement:

- Cemetery organizations
- Civic organizations
- Fraternal organizations
- Labor unions
- Libraries
- Museums
- Other cultural institutions
- Performing arts organizations
- Political parties
- Private and community foundations
- Private elementary and secondary schools
- Professional associations
- Public broadcasting stations
- Religious organizations
- Research and scientific organizations

Social and country clubs
Trade associations
Zoological and botanical societies

.006 This statement of position applies to many diverse organizations. Some believe that separate accounting guidelines should be issued that fit the special requirements of each type of organization. Others, however, have criticized the published guides and this statement of position because of inconsistencies among the guides, contending that many of the inconsistencies cannot be justified. The accounting standards division believes that continuing to publish separate accounting papers or guidelines for different types of organizations would proliferate accounting practices unnecessarily. Similar transactions generally should be treated similarly by all organizations. The accounting standards division believes that it has considered the principal special requirements or conditions of the organizations covered by this statement of position and has provided special rules or exceptions where deemed appropriate.

.007 Some have contended that the division has not sufficiently considered the costs and efforts involved in implementing its recommendations—especially for smaller organizations. Some organizations may believe that special-purpose reports prepared on a basis other than generally accepted accounting principles better serve their needs—especially in light of the relationship between costs and benefits; these recommendations do not preclude such organizations from continuing to use appropriate special-purpose reports.

USERS OF FINANCIAL STATEMENTS

.008 A wide variety of persons and groups are interested in the financial statements of nonprofit organizations. Among the principal groups are (a) contributors to the organization, (b) beneficiaries of the organization, (c) the organization's trustees or directors, (d) employees of the organization, (e) governmental units, (f) the organization's creditors and potential creditors, and (g) constituent organizations.

.009 A principal purpose of a nonprofit organization's financial statements is to communicate the ways resources have been used to carry out the organization's objectives. It requires reporting the nature and amount of available resources, the uses made of the resources, and the net change in fund balances

during the period. In addition, while adequate measures of program accomplishment generally are not available in the context of present financial statements, the financial statements should identify the organization's principal programs and their costs. A third aspect of financial reporting for nonprofit organizations is disclosure of the degree of control exercised by donors over use of resources. A fourth aspect is that the financial statements of a nonprofit organization should help the reader evaluate the organization's ability to carry out its fiscal objectives.

.010 The division has prepared this statement of position based on the foregoing concepts as a guide to preparing financial statements to be used primarily by persons outside the management of the organization. It recognizes that financial statements prepared for use by management or members of the governing board often require more detail than is prescribed in this statement.

ACCRUAL BASIS OF ACCOUNTING

.011 The accrual basis of accounting is widely accepted as providing a more appropriate record of all an entity's transactions over a given period of time than the cash basis of accounting. The cash basis or any basis of accounting other than the accrual basis does not result in a presentation of financial information in conformity with generally accepted accounting principles. Accordingly, financial statements of nonprofit organizations represented as being in conformity with generally accepted accounting principles should be prepared using the accrual basis of accounting.¹

.012 For example, under accrual basis accounting, goods and services purchased should be recorded as assets or expenses at the time the liabilities arise, which is normally when title to the goods passes or when the services are received. Encumbrances representing outstanding purchase orders and other commitments for materials or services not yet received are not liabilities as of the reporting date and should not be reported as expenses nor included in liabilities on the balance sheet. However, significant commitments should be disclosed in the notes to the financial statements, and an organization may designate in its balance sheet the portion of the fund balance so committed.

¹ Some organizations keep their books on a cash basis throughout the period and, through adjustment at the end of the period, prepare statements on the accrual basis. The requirement is only that the financial statements be presented on the accrual basis and not that the books be kept on that basis throughout the period.

.013 For numerous nonprofit organizations, complex accounting procedures may be neither practical nor economical, and reporting based essentially on cash receipts and disbursements may be adequately informative. If financial statements prepared on the cash basis are not materially different from those prepared on the accrual basis, the independent auditor may still be able to conclude that the statements are presented in conformity with generally accepted accounting principles. Otherwise, cash basis financial statements should be considered to be special purpose financial statements and should be reported on accordingly.

FUND ACCOUNTING

.014 Many nonprofit organizations receive resources restricted for particular purposes. To facilitate observance of limitations, the accounts are often maintained using fund accounting, by which resources are classified for accounting and reporting purposes into funds associated with specified activities or objectives. Each fund is a separate accounting entity with a self-balancing set of accounts for recording assets, liabilities, fund balance, and changes in the fund balance. Although separate accounts are maintained for each fund, the usual practice in preparing financial statements is to group funds that have similar characteristics.

.015 The division believes that reporting on a fund accounting basis may be helpful where needed to segregate unrestricted from restricted resources. If an organization has restricted resources and elects not to report on a fund accounting basis, the financial statements should disclose all material restrictions and observe the specific requirements indicated in paragraphs .016 through .041, "Basic Financial Statements."

BASIC FINANCIAL STATEMENTS

.016 The basic financial statements, including related notes, of nonprofit organizations covered by this statement are—

- Balance sheet
- Statement of activity
- Statement of changes in financial position

.017 The balance sheet is intended to present financial position. The statement of activity, including changes in fund bal-

ances, is intended to present results of operations. However, when it is intended that the financial statements present both financial position and results of operations, all three statements listed in paragraph .016 should be presented.

.018 Although the division has identified the basic financial statements to be prepared, for the most part, it does not prescribe specific titles or formats. Each organization should develop the statement formats most appropriate to its needs in conformity with the principles discussed in this statement. A number of illustrative financial statements are presented in Appendix C to demonstrate the diversity of formats that can be used.

Balance Sheet

.019 The balance sheet should summarize the assets, liabilities, and fund balances of the organization.

.020 An organization's unrestricted fund balance represents the net amount of resources available without restriction for carrying out the organization's objectives. Those resources include amounts designated by the board for specific purposes, undesignated amounts, and, frequently, amounts invested in operating plant. While the balance sheet may set forth amounts designated for a program or other purposes, the total of all unrestricted fund balances, other than amounts shown in a plant fund, as discussed in paragraph .022, should be shown and labeled on the balance sheet.

.021 Current restricted resources and resources restricted for future acquisition of fixed assets should be reported in the balance sheet as deferred revenue until the restrictions are met. Other restricted resources such as endowment funds should be reflected separately in the fund balance section of the balance sheet. If significant, the nature of the restrictions on fund balances and deferred revenues should be described in the notes to the financial statements.

.022 Many organizations use a separate fund to account for the investments in operating plant, art collections, rare books and manuscripts, and similar items. The sources of the funds used to acquire those assets often are a combination of unrestricted and restricted funds. It may not be clear whether assets purchased with restricted funds continue to bear the original donor restrictions. While the division believes an organization should indicate whether the fund balances are restricted or un-

restricted, that may not be possible for the plant fund. Thus, the plant fund may be reported separately or combined with either the unrestricted or restricted funds, as appropriate.

.023 Many organizations covered by this statement have only unrestricted funds. Those organizations should classify their assets as current, fixed, and other long-term assets and should classify their liabilities as current and long-term. To be classified as “current,” the assets generally should be realizable and the liabilities payable within a normal operating cycle; however, if there is no normal operating cycle or the operating cycle is less than one year, all assets expected to be converted to cash or other liquid resources within one year and all liabilities to be liquidated within one year should be classified as current.

.024 Other organizations have both unrestricted and restricted funds. Frequently, the fund classifications themselves adequately disclose the current and long-term nature of the assets and liabilities. If not, a classified balance sheet should be presented.

Statement of Activity

.025 Throughout this statement of position the term *statement of activity* identifies the financial statement that reports the support, revenue, capital or nonexpendable additions, and functional expense categories. The statement might carry a different title, such as *statement of support, revenue, expense, capital additions, and changes in fund balances*, or simply *statement of changes in fund balances*. The statement of activity should include the activity for the period and a reconciliation between the beginning and ending fund balances. However, an organization may prepare two separate statements: a statement of activity and a statement of changes in fund balances. Changes in fund balances should include the excess or deficiency of revenue and support over expenses after capital additions for the period, adjustments to reflect changes in the carrying amount of certain marketable securities and other investments, as discussed in paragraph .080, and the additions and deductions of interfund transfers.

.026 The division has considered the diverse practices used to report details of financial activity. It has concluded that variations in format and presentation are appropriate, provided that the statement of activity shows the major sources and amounts

of revenue and support, as well as the principal sources and amounts of additions to plant, endowment, and other capital funds. This does not prohibit an organization from reporting revenue and expenses separately from sources of support in its financial statements.

.027 Nonprofit organizations derive revenues from a variety of sources—dues, sale of services, ticket sales, investment income, and so forth—but they are often not sufficient to cover the cost of providing services. Many organizations, therefore, solicit support to enable them to fulfill their program objectives. Such support may be obtained from individuals, foundations, corporations, governmental units, and other entities.

.028 Certain contributions cannot be spent currently for program or supporting services because of donor or legal restrictions and have many of the characteristics of “capital.” Such items include gifts, grants, and bequests to endowment, plant, and loan funds restricted either permanently or for a period of time by parties outside the organization. Those items also include investment income that has been restricted by donors and gains or losses on investments held in such funds that must be added to the principal.² The accounting standards division has concluded that disclosure of those items would be useful, and they should be differentiated from items that are available for current operations. Captions such as “capital additions,” or “nonexpendable additions,” should be used.

.029 Capital additions do not include restricted gifts, grants, bequests, or gains on the sale of assets that can be used for current activities even though the contributions have been deferred until the organization incurs an expense that satisfies the terms of the restriction, nor do they include unrestricted amounts that the board designates as nonexpendable. See paragraphs .054 through .062 for a further discussion on current restricted gifts, grants, bequests, and other income.

.030 While there is wide diversity of practice, the division concluded that an “excess” line-item caption in the statement of activity is useful. Although the purpose of the organizations covered by this statement is not to make “profits” as this term is generally used, nonprofit entities can survive only if they have support, revenue, and other additions equal to or in excess

² The division does not suggest that gains on the sales of restricted assets are legally restricted or that they cannot be used at the discretion of the organization. Those are legal questions that depend on applicable law, donor intent, or both.

of expenses. This measure is an important indicator of financial health and is therefore of interest to management, members of the governing board, donors, beneficiaries, and other users of the financial statements. Accordingly, the statement of activity should report the excess (deficiency) of revenues and support over expenses for the period.

.031 If financial activities include capital additions, there should be *two* clearly labeled “excess” line-item captions, such as “excess (deficiency) of revenue and support over expenses before capital additions” and “excess (deficiency) of revenue and support over expenses after capital additions” (alternative wording may be used).

Statement of Changes in Financial Position

.032 The statement of changes in financial position provides a summary of available resources and their use during the period.

.033 Many nonprofit organizations obtain their resources from contributions, borrowed money, investment income, and so forth. The statement of changes in financial position provides the user with information about both the methods of financing programs and activities and the use and investment of resources during the period.

.034 The statement of changes in financial position should summarize all changes in financial position, including capital additions, changes in deferred support and revenue, and financing and investing activities.

Other Types of Fund Classifications

.035 Rather than using the traditional fund accounting classifications, some organizations prefer using classifications such as expendable and nonexpendable or unrestricted and restricted in their financial statements. Such classifications are appropriate provided that all the required disclosures indicated in paragraphs .016 through .041 are met.

Columnar v. Layered Presentation

.036 The practice of presenting data by major fund groups has evolved to emphasize meaningful distinctions between the types of unrestricted and restricted resources for which an organization is accountable. Many organizations report finan-

cial position and results of activities in a multicolumn format. Others report their financial statements in a layered or "pancake" format, and still others report certain data in a columnar format and other data in a layered format. Each organization should develop the statement format most appropriate to its needs to conform with the principles discussed in this statement of position.

Totals of All Funds

.037 Some organizations present their financial statements (either in columnar or layered format) only by major fund groups without showing totals of all funds. They do not consider totals of all funds to be meaningful and sometimes consider such totals to be misleading because of restrictions on the use of certain resources; however, other organizations, believing that totals are meaningful, present details by major fund groups and totals of all funds in one or more of their statements.

.038 Certain organizations present financial statements showing only the totals of all funds and do not show the major fund groups. Organizations do that if they do not establish separate funds for reporting purposes, if the financial information concerning particular funds is not significant, or if such information can be adequately set forth in other ways in the statements or the notes.

.039 Financial statements in columnar format lend themselves to presenting totals of all funds. Financial statements presented in layered format lend themselves to fund group presentations with comparative data for the preceding period.

.040 The presentation of totals of all fund groups in all financial statements is preferable, although not required. In presenting such totals, the specifics of the major fund groups should also be provided, and care should be taken to assure that the captions are not misleading and that adequate information is provided concerning interfund borrowings and important restrictions on the uses of resources.

Comparative Financial Statements

.041 Although it is not required, financial statements of the current period should be presented on a comparative basis with financial statements for one or more prior reporting periods. If multi-column financial statements are presented for the current period, some organizations prefer to present only sum-

marized, total-all-funds information (in a single column) for each of the prior periods because of space limitations and to avoid the confusion that a second set of multi-column statements might cause. However, where it is intended to present financial statements of the prior periods as well as the current period in accordance with generally accepted accounting principles, care must be taken that there is sufficient disclosure in the summarized data and in the supporting notes.

FINANCIALLY INTERRELATED ORGANIZATIONS

.042 For a reporting organization that controls another organization having a compatible purpose, it is presumed that combined or combining financial statements are more meaningful than separate statements and are usually necessary for a fair presentation in conformity with generally accepted accounting principles. *Control* means the direct or indirect ability to determine the direction of the management and policies through ownership, by contract, or otherwise.

.043 The accounting standards division has considered the foregoing definition in relation to the nonprofit organizations covered by this statement of position and has concluded that it may be construed by some to be so broad, considering the structure of some nonprofit organizations, that presentation of combined financial statements might have relatively little value to users of such combined statements, particularly in relation to the cost of their preparation.

.044 Nevertheless, the division has concluded that combined financial statements are necessary for informative presentation of certain financially interrelated organizations. To balance these objectives, combined financial statements should be presented if (1) control exists as defined in paragraph .042 and (2) any of the following circumstances exists:

- a. Separate entities solicit funds in the name of and with the expressed or implicit approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
- b. A reporting organization transfers some of its resources to another separate entity whose resources are held for the benefit of the reporting organization.

- c. A reporting organization assigns functions to a controlled entity whose funding is primarily derived from sources other than public contributions.

The basis for combining financial statements, including the interrelationship of the combined organizations, should be disclosed in the notes to the financial statements.

.045 Legally unrestricted resources held by organizations related to the reporting organization may be effectively restricted with respect to the reporting organization. In combined financial statements that include both the related organization and the reporting organization, it may be appropriate to present all resources of the related organization, both unrestricted and restricted, as restricted resources.

.046 A national or international organization may have state or local chapters with varying degrees of autonomy. Affiliated organizations may be separate corporate entities or unincorporated boards, committees, or chapters. It is not intended to require a national or "parent" organization with loosely affiliated local organizations whose resources are principally derived and expended locally to combine the local organizations' financial statements with its own. The loose affiliation of the local organization would be characterized by locally determined program activities, financial independence of the local organization, and local organization control of its assets. Therefore, combined financial statements need not be presented unless the financial relationships between the entities are as described in paragraph .044.

.047 If affiliated organizations are not combined because they do not meet the combining criteria or have loosely affiliated local organizations, the existence of the affiliates and their relationships to the reporting organization should be disclosed.

.048 In view of the unique and complex organizational relationships and degrees of local autonomy common in religious organizations, there may be many circumstances in which application of this section on combination would not result in meaningful financial information. Thus, if a religious organization concludes that meaningful financial information would not result from the presentation of combined financial statements, the provisions of this section need not be applied.

Related-Party Transactions

.049 Contributions made to an organization by its governing board members, officers, or employees need not be separately disclosed if the contributors receive no reciprocal economic benefits.

REVENUE, SUPPORT, AND CAPITAL ADDITIONS

.050 The statement of activity should report revenue, support, and capital additions. Revenue and support are discussed under "Statement of Activity," paragraphs .025 through .031.

Capital Additions

.051 Capital additions include nonexpendable gifts, grants, and bequests restricted by donors to endowment, plant, or loan funds either permanently or for extended periods of time. Capital additions also include legally restricted investment income and gains or losses on investments held in such funds that must be added to the principal.³ Capital additions do not include donor-restricted gifts for program or supporting services.

.052 Capital additions that are restricted for acquisition of plant assets should be treated as deferred capital support in the balance sheet until they are used for the indicated purpose. Once used, these amounts should be reported as capital additions in the statement of activity.

.053 Some organizations may prefer to use the caption "non-expendable additions" instead of "capital additions." As previously noted, that or other wording is acceptable.

Current Restricted Gifts, Grants, Bequests, and Other Income

.054 Current restricted gifts, grants, bequests, and other income provide expendable resources that have been restricted by donors, grantors, or other outside parties to the purposes for which they may be used. Such restrictions usually involve written assertions expressed in restrictive language by one party to the other. Amounts received from appeals for restricted funds by solicitation letter, radio, television, newspaper, and so forth are generally deemed to be restricted according to the nature of the appeal.

³ See footnote 2

.055 Two alternative accounting conventions have been used for reporting current restricted resources. Some report the full amount of such resources when received as "revenue and support" in a current restricted fund column in the statement of activity, without regard to whether the resources were used or the restrictions met.⁴ Unspent amounts are reported in the "excess (deficiency) of revenue and support over expenses" and included in the fund balance of the current restricted fund.

.056 This accounting convention is used because restricted resources are available for current use regardless of whether they are spent, and full accountability requires that this be recognized by reflecting receipt of such resources as revenue and support. Those who disagree express concern that the recognition of such amounts as revenue and support overlooks the legal obligation to return the resources if they are not used for the restricted purpose. They further contend that large amounts received near the end of the period may significantly distort the financial statements of the organization.

.057 The other accounting convention has been based on an assumption that a donee organization should not recognize such amounts as revenue until the particular resources are used for the purpose specified by the donors, since they are not "earned" until they are used and the restrictions met.⁵ Under this accounting convention, receipts of current restricted funds are not reported as revenue until the resources are expended for the purpose specified. Until then, they are reported as a direct addition to the fund balance of the current restricted fund.

.058 This approach may be satisfactory for restricted grants that impose conditions of discrete accountability with the requirement that unspent balances be refunded to the grantors. However, it allows management to defer recognition of restricted support as revenues although applicable expenses have been incurred.

.059 The accounting standards division believes that neither accounting convention is entirely satisfactory and that the conventions should be changed based on the following concepts:

- a. The recognition of the receipt of restricted funds as revenues should be determined by economic events rather than by

⁴This is the approach recommended by the AICPA industry audit guide, *Audits of Voluntary Health and Welfare Organizations* (New York: AICPA, 1974).

⁵This is the approach recommended by the AICPA industry audit guides for hospitals and for colleges and universities.

arbitrary management decisions. The same economic events affecting two similar organizations in a similar manner should not appear to produce two different results because of differences in the management objectives.

- b. For accounting purposes, donor restrictions are complied with when the organization incurs an expense for the function, program, project, or object and in the manner specified in the donative instrument or grant award unless such expense is attributable to other restricted funds.
- c. Unexpended restricted funds should be reported in a manner that reflects the restrictions attached to such funds.

.060 For example, if a donor restricted a contribution or responded to an appeal for restricted contributions to be used for a specific program service and the organization subsequently, or in anticipation of receiving the restricted contributions, incurred expenses for that particular program service, the accounting standards division believes the obligation imposed by the restriction should be deemed to have been met even if unrestricted funds were used. Management should not avoid recognizing the restricted contribution as support in that period simply because it chose to use dollars attributed to unrestricted funds at the time the expense was incurred.

.061 Unless the donor specifies to the contrary, the donee organization should consider only expenses incurred after the receipt of the restricted contribution as meeting the restriction. This does not apply if the donor or grantor contributes in response to an appeal that specifies that the related expenses may have already been incurred in whole or in part.

.062 The division has concluded, therefore, that current restricted gifts, grants, bequests, and other income should be accounted for as revenue and support in the statement of activity to the extent that expenses have been incurred for the purpose specified by the donor or grantor during the period. The balances should be accounted for as deferred revenue or support in the balance sheet outside the fund balance section until the restrictions are met. The specific language in the donative instrument or grant award should govern whether restrictions have been met. Recognition of expenses that satisfy donor restrictions results in recognition of equivalent amounts of revenue or support in that period.

Unrestricted Gifts, Grants, and Bequests

.063 Unrestricted gifts, grants, and bequests should be reported in the unrestricted fund in the statement of activity above the caption "excess (deficiency) of revenue and support over expenses before capital additions."

Pledges

.064 Pledges an organization can legally enforce should be recorded as assets and reported at their estimated realizable values. In determining these values, such matters as the donee organization's past collection experience, the credit standing of the donor, and other matters affecting the collectibility of the pledges should be considered.

.065 The estimated realizable amount of pledges should be recognized as support in the period designated by the donor. If the period designated by the donor extends beyond the balance sheet date, the pledge should be accounted for as deferred support in the balance sheet. In the absence of a specified support period, the net estimated realizable amount of pledges scheduled to be received over a future period should be assumed to be support for that period and should be accounted for as deferred support in the balance sheet.

.066 Pledges for fixed assets should also be recorded in the balance sheet at their estimated realizable values and reported in the statement of activity as provided in paragraph .052.

Donated and Contributed Services

.067 The nature and extent of donated or contributed services received by organizations vary and range from the limited participation of many individuals in fund-raising activities to active participation in the organization's service program. Because it is difficult to place a monetary value on such services, their values are usually not recorded. The accounting standards division believes that those services should not be recorded as an expense, with an equivalent amount recorded as contributions or support, unless all of the following circumstances exist:

- a. The services performed are significant and form an integral part of the efforts of the organization as it is presently constituted; the services would be performed by salaried personnel if donated or contributed services were not available for

the organization to accomplish its purpose; and the organization would continue this program or activity.

- b. The organization controls the employment and duties of the service donors. The organization is able to influence their activities in a way comparable to the control it would exercise over employees with similar responsibilities. This includes control over time, location, nature, and performance of donated or contributed services.
- c. The organization has a clearly measurable basis for the amount to be recorded.
- d. The services of the reporting organization are not principally intended for the benefit of its members. Accordingly, donated and contributed services would not normally be recorded by organizations such as religious communities, professional and trade associations, labor unions, political parties, fraternal organizations, and social and country clubs.

.068 Participation of volunteers in philanthropic activities generally does not meet the foregoing criteria because there is no effective employer-employee relationship. (See criterion *b*, above.)

.069 Services that generally are not recorded as contributions, even though the services may constitute a significant factor in the operation of the organization, include the following:

- a. Supplementary efforts of volunteer workers that are provided directly to beneficiaries of the organization. Such activities usually involve auxiliary activities or other services that would not otherwise be provided by the organization as a part of its operating program.
- b. Periodic services of volunteers in concentrated fund-raising drives. The activities of volunteer solicitors are not usually subject to a degree of operating supervision and control by the organization sufficient to provide a basis for measuring and recording the value of time devoted. However, if individuals perform administrative functions in positions that would otherwise be held by salaried personnel, consideration should be given to recording the value of those services.

.070 Notes to the financial statements should disclose the methods used by the organization in valuing, recording, and reporting donated or contributed services and should distinguish

between donated or contributed services for which values have and have not been recorded.

Donated Materials and Facilities

.071 Donated material and facilities, if significant in amount, should be recorded at their fair value, provided the organization has a clearly measurable and objective basis for determining the value. If the materials are such that values cannot reasonably be determined, such as clothing, furniture, and so forth, which vary greatly in value depending on condition and style, they should not be recorded as contributions. If donated materials pass through the organization to its charitable beneficiaries, and the organization serves only as an agent for the donors, the donation should not be recorded as a contribution. The recorded value of the use of contributed facilities should be included as revenue and expense during the period of use.

Investment Income and Gains and Losses

.072 Unrestricted investment income (interest and dividends) from all funds should be reported as revenue in the statement of activity when it is earned. All unrestricted gains and losses on investments of unrestricted and current restricted funds should also be reported in the statement of activity before the excess (deficiency) of revenue and support over expenses before capital additions. See paragraphs .077 through .082 for a discussion of the carrying amount of investments and the bases of reporting gains and losses.

.073 As discussed in paragraph .021, restricted investment income and restricted gains and losses from investments of current restricted funds and restricted plant funds should be reported as deferred amounts in the balance sheet. Restricted expendable income from investments of endowment funds should also be reported as deferred amounts. Income from investments of endowment funds that must be added to the principal by direction of the donor should be reported as capital additions. Gains and losses on investments of endowment funds should be reported as capital additions or deductions.

.074 Traditionally, nonprofit organizations have accounted for income yield (dividends, interest, rents, royalties, and so forth) as revenues available for current purposes and have excluded from that category capital gains on investment transactions of the endowment fund.

.075 In recent years, some institutions have adopted what is usually referred to as a “total return” approach to the management of investments of endowment and quasi-endowment funds. This investment approach emphasizes total investment return consisting of traditional yield plus or minus gains and losses. Typically, the governing board establishes a “spending rate” that is satisfied by traditional yield first, that is, by dividends and interest. To the extent that traditional yield is inadequate to meet the spending rate, the governing board may make a portion of realized, and in some cases unrealized, net gains available for current use. The use of net gains on investments of true endowment funds by the governing board is usually done with the advice of legal counsel.

.076 A problem arises in the method of accounting for the available net gains from endowment funds because the concept thus far has produced few, if any, applications that appear to be objectively determinable. For example, some institutions have reported net gains made available as revenues, while most others follow existing AICPA industry audit guides and account for this transaction as a transfer from endowment funds to other funds. In some situations when traditional yield has exceeded the spending rate, the excess has been added directly to endowment fund balances rather than being reported as revenue. The spending rate policies of many institutions tend to place primary emphasis on spending without regard to the effect on endowment fund principal. While all of the total return approaches emphasize the use of prudence and a rational and systematic formula, those matters are subjective and not susceptible to measurement. Consequently, the accounting standards division concludes that the portion of available net gains from endowment investments utilized should be reported in the statement of activity as a transfer from endowment funds to other funds. To the extent such gains are transferred to a restricted fund in which unexpended gifts and investment income are reported as deferred support and revenues, the gains should be transferred to deferred revenue of that fund. Since quasi-endowment funds are to be accounted for as a part of current funds, using net gains on the investments of these funds does not involve a transfer. Such gains and losses should be accounted for in the manner specified in paragraph .072.

Carrying Amount of Investments

.077 Nonprofit organizations have traditionally carried purchased investments at cost and donated investments at fair value at date of receipt. Investments have normally been written down to market value when market values have declined below the carrying value and the declines were deemed to be permanent impairments. Beginning in 1973 with the issuance of the AICPA industry audit guide for colleges and universities, some nonprofit organizations have been carrying their investments at market, as a permissible alternative to cost, adjusting the carrying amount each year for value increases and decreases.

.078 An organization carrying investments at market value recognizes the gains or losses that result from market fluctuations for the period in which the fluctuations occur. Those who are against carrying investments at market are concerned both with the difficulty of valuing nonmarketable investments and the effect that market fluctuations have on an organization's results of activity as reflected in the financial statements.

.079 The division has concluded that organizations covered by this statement of position should report investments in the financial statements as follows:

- Marketable debt securities, when there is both the ability and intention to hold the securities to maturity, should be reported at amortized cost, market value, or the lower of amortized cost or market value;
- Marketable equity securities and marketable debt securities that are not expected to be held to maturity should be reported at either market value or the lower of cost or market value;
- Other types of investments, for example, real estate or oil and gas interests, should be reported at either fair value or the lower of cost or fair value.

The basis selected to value each of these three groups of investments should apply to all investments in that group. When investments are carried at other than market value, disclosure of market value for that group at the balance sheet date should be made.

.080 For investments carried at the lower of (amortized) cost or market value, the division believes that declines should be recognized when the aggregate market value by fund group is less than the carrying amount. Recoveries of aggregate

market amount in subsequent periods should be recorded in those periods subject only to the limitation that the carrying amount should not exceed the original cost. The adjustments to recognize the increases or decreases resulting from the application of this paragraph for noncurrent investments should be recognized as a direct addition or deduction to the fund balance; the adjustments applicable to current investments should be reflected in the statement of activity in the same manner as realized gains and losses. Investments held in current restricted funds should normally be considered to be current investments for purposes of this paragraph.

.081 For investments carried at market value, increases or decreases in market value should be recognized in the period in which they occur, as described in paragraphs .072 and .073.

.082 Interfund sales or exchanges of investments that involve a restricted fund should be recorded in the purchasing fund at fair value. The difference between the carrying amount and the fair value at the date of the sale or exchange should be accounted for in the selling fund in the same manner as realized gains and losses and appropriately disclosed.

.083 The notes to the financial statements should set forth a summary of the total realized and unrealized gains and losses and income derived during the fiscal period from investments held by all funds except life income and custodial funds.

Subscription and Membership Income

.084 Subscriptions and revenues derived from the performance of services or the sale of goods should be recognized as revenue in the periods in which they are provided. Revenue derived from membership dues should be recognized by the organization over the period to which the dues relate. Non-refundable initiation and life membership fees should be recognized as revenue in the period the fees are receivable, if future dues or fees can reasonably be expected to cover the cost of future services; otherwise, the fees should be amortized to future periods based on average membership duration, life expectancy, or other appropriate methods. However, if items such as dues, assessments, and nonrefundable initiation fees are in substance contributions and services are not to be provided to the member, they should be recognized as revenue and support in the periods in which the organization is entitled to them.

EXPENSES**Functional Classification of Expenses**

.085 Organizations that receive significant support in the form of contributions from the general public should summarize the cost of providing various services or other activities on a functional basis in the statement of activity. (For purposes of this paragraph, the accounting standards division believes that organizations receiving support from federated fund-raising or similar organizations are deemed to have received support from the general public.) Organizations receiving no significant support from such contributors are encouraged to report on a functional basis but may choose to summarize expenses on another basis (such as natural classifications) that would be considered useful to readers of the statement of activity. If expenses are not reported on a functional basis, the notes should contain a description of the basic programs of the organization. The remainder of this section is for those organizations that report expenses on a functional basis.

.086 The functional classifications should include specific program services that describe the organization's service activities and supporting services, such as management and general and fund-raising.

.087 The statement of activity should present costs separately for each significant program and supporting activity. Program activities are those directly related to the purposes for which the organization exists. Supporting activities do not relate directly to the purposes for which the organization exists. Fund raising, membership development, and unallocated management and general expense are three examples of supporting activities that should be reported separately.

.088 An organization may also present as supplementary information a schedule of functional expenses by object classification, that is, classifying expenses by type rather than function, such as salaries, employee-benefit expenses, and purchased services.

Program Services

.089 Functional reporting classifications for program services vary according to the nature of the service rendered. For some organizations, a single functional reporting classification may be adequate to portray the program service provided. In

most cases, however, several separate and identifiable services are provided, and in such cases, expenses for program services should be reported by the type of service function or group of functions. The purposes of the various functions should be clearly described, and each functional classification should include all of the applicable service costs.

.090 Some local organizations remit a portion of their receipts to an affiliated state or national organization. The amount to be paid to the affiliates should be reported as either an expense or a deduction from total support and revenue in the statement of activity. The appropriate treatment depends on the arrangements: A reporting organization that is, in effect, a collecting agent for the state or national organization, such as local organizations that are required to remit a fixed percentage of all contributions, should report the remittance as a deduction from total support and revenue; other organizations should report the remittance as a program expense.

Management and General Costs

.091 Management and general costs are those not identifiable with a single program or fund-raising activity but are indispensable to the conduct of those activities and to an organization's existence, including expenses for the overall direction of the organization's general board activities, business management, general recordkeeping, budgeting, and related purposes. Costs of overall direction usually include the salary and expenses of the chief officer of the organization and his staff. However, if such staff spend a portion of their time directly supervising program services or categories of supporting services, their salaries and expenses should be prorated among those functions. The costs of disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, the annual report, and so forth, should likewise be classified as management and general expenses.

Fund-Raising and Other Supporting Services

.092 Fund-raising costs are incurred in inducing others to contribute money, securities, time, materials, or facilities for which the contributor will receive no direct economic benefit. They normally include the costs of personnel, occupancy, maintaining mailing lists, printing, mailing, and all direct and indirect costs of soliciting, as well as the cost of unsolicited

merchandise sent to encourage contributions. The cost of such merchandise should be disclosed. Fund-raising costs paid directly by a contributor should be reported as support and as fund-raising expenses.

.093 Some organizations hold special fund-raising events, such as banquets, dinners, theater parties, and so forth, in which the donor receives a direct benefit (for example, a meal or theater ticket). Some organizations sell merchandise as a fund-raising technique. The costs of such merchandise or direct benefits are not considered fund-raising costs and should be applied against gross proceeds received from the person receiving such direct benefit. The costs of such merchandise or direct benefit costs should be disclosed.

.094 A growing number of users of financial statements are seeking financial information that will enable them to evaluate fund-raising costs. A single functional reporting classification ordinarily is adequate to portray the fund-raising activity; however, other organizations may believe that reporting total public support and total fund-raising expense does not provide adequate information for a useful evaluation because the organizations conduct a number of fund-raising activities with widely varying relationships. For those organizations, it may be appropriate to report fund-raising costs and the corresponding support obtained separately for each type of fund-raising function, either in the statement of activity or in the notes. The various fund-raising functions should be adequately described and should include all of the applicable costs. The total of all fund-raising activities should be disclosed whether the entity reports expenses on a functional or some other basis.

.095 Fund-raising efforts made in one year, such as those made to obtain bequests or to compile a mailing list of prospective contributors, often result in contributions that will be received in future years. Some have advocated deferring the costs of such fund-raising efforts until the period in which the contributions are expected to be received. Although there may be valid reasons to consider deferring those costs, the accounting standards division is concerned with the difficulty of assessing their ultimate recovery and the possibility of misstating the fund-raising cost relationships. Accordingly, fund-raising costs should be expensed when incurred. However, if pledges or restricted contributions that have already been received are recorded as deferred revenue and support, related fund-raising costs, if specifically identifiable with the contributions, may also

be deferred if it is clear that the contributor intended that the contribution could be used to cover such costs. Similarly, costs incurred in the acquisition of literature, materials, and so forth, that will be used in connection with a fund-raising drive to be conducted in a succeeding period should be deferred to that period.

.096 Costs incurred in the solicitation of grants from foundations or governments and cost of membership development in bona fide membership organizations should be shown as separate categories of supporting expenses. If the membership fee includes an element of contribution, the costs of membership development should be allocated between membership development and fund raising.

.097 If an organization combines the fund-raising function with a program function (for example, a piece of educational literature with a request for funds), the costs should be allocated to the program and fund-raising categories on the basis of the use made of the literature, as determined from its content, the reasons for its distribution, and the audience to whom it is addressed.

Allocation of Costs That Pertain to Various Functions

.098 In some larger organizations, individual functions are performed by separate departments, with expenses classified by types within each department. Many other organizations incur items of cost that apply to more than one functional purpose. For those organizations, it may be necessary to allocate the costs among functions. Examples include salaries of persons who perform more than one type of service, rental of a building used for various program services, management and general expenses, and expenses of fund-raising activities.

.099 The salaries of employees who perform duties relating to more than one function, as well as all other expenses pertaining to more than one function, should be allocated to the separate functional categories according to procedures that determine, as accurately as possible, the portion of the cost related to each function.

.100 A reasonable allocation of an organization's functional expenses may be made on a variety of bases, and costs that have been allocated to programs and supporting services should be disclosed in the notes to the financial statements. It is not

the intention of this statement to require organizations to undertake extensive detailed analyses and computations aimed at making overly meticulous allocations. The division recognizes that meaningful financial statements can often be prepared using estimates and overall computations when appropriate. (See Appendix B for illustrative allocation procedures.)

Grants

.101 Organizations that make grants to others should record grants as expenses and liabilities at the time recipients are entitled to them. That normally occurs when the board approves a specific grant or when the grantee is notified.

.102 Some grants stipulate that payments are to be made over a period of several years. Grants payable in future periods subject only to routine performance requirements by the grantee and not requiring subsequent review and approval for continuance of payment should be recorded as expenses and liabilities when the grants are first made. However, if the grant instrument specifically states that the grantor reserves the right to revoke the grant regardless of the performance of the grantee, unpaid grants should not be recorded. Grants subject to periodic renewal should be recorded as expenses and liabilities at renewal with a disclosure of the remaining commitment in the notes to the financial statements.

Tax Allocation

.103 Certain organizations are subject to a federal excise tax on investment income or to federal and state income taxes on certain unrelated business income. If timing differences exist between the income base for tax and financial reporting purposes, interperiod allocation of tax should be made.

Transfers

.104 Allocations of resources among fund groups are neither revenues nor expenses of the related funds and should be distinguished from support and revenues that increase the total resources available to fulfill the objectives of an organization. Therefore, interfund transfers, including board-designated transfers of gains under the total-return concept, should be reported as changes in fund balances under the caption "fund balance beginning of the period." Transfers required under contractual arrangements with third parties should be separately disclosed. Transfers required as a result of the expiration of a term endowment fund also should be separately disclosed.

BALANCE SHEET

Fixed Assets

.105 Nonprofit organizations should capitalize purchased fixed assets at cost. Donated fixed assets should be recorded at their fair value at the date of the gift. Organizations that have not previously capitalized their fixed assets should do so retroactively. If historical costs are unavailable for assets already in service, another reasonable basis may be used to value the assets. Other bases might be cost-based appraisals, insurance appraisals, replacement costs, or property tax appraisals adjusted for market. However, an alternative basis should be used only if historical cost information is unavailable and only to establish a value at the date an organization adopts this statement of position. Subsequent additions should be recorded at cost, or fair value for donated assets. The basis of valuation and the amount of any assets pledged to secure outside borrowing should be disclosed in the financial statements.

Depreciation

.106 In Accounting Terminology Bulletin no. 1, *Review and Résumé*, the AICPA Committee on Terminology, defined *depreciation accounting* as a means of allocating the cost or other carrying value of tangible capital assets to expense over their useful lives:

Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not valuation. *Depreciation for the year* is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

.107 Exhaustible fixed assets should be depreciated over their estimated useful lives. The relative effort being expended by one organization compared with others and the allocation of the efforts to various programs of the organization are indicated, in part, by cost determinations. Depreciation of fixed assets used in providing such services is relevant as an element of that cost. Although depreciation can be distinguished from most other elements of cost in that it requires no current equivalent cash outlay, recognition of depreciation as a cost is not optional. Most assets used in providing services are both valuable and

exhaustible. Thus, a cost is associated with the use of exhaustible assets whether they are owned or rented, acquired by gift or by purchase or used by a business or a nonprofit organization.

.108 Assets that are not exhaustible, such as landmarks, monuments, cathedrals, or historical treasures, need not be depreciated. Structures used primarily as houses of worship need not be depreciated.

.109 An organization may receive grants, allocations, or reimbursements from other organizations on the basis of the cost associated with its program and supporting services. Recording depreciation as an element of cost does not indicate that it necessarily should be included in the base on which grants, allocations, or reimbursements will be determined: whether the base includes or excludes depreciation depends on the agreement or understanding reached between the two organizations.

.110 The amount of depreciation provided on assets carried at historical cost and the amount, if any, provided on assets carried on a basis other than historical cost should be disclosed.

.111 Depreciation accounting is sometimes confused with funding replacements. The means of replacing fixed assets and the degree to which replacements should be funded currently are financing decisions to be made by the governing board and do not directly affect the current costs of providing program or supporting services. Depreciation accounting is designed to determine and present those costs, not to provide replacement funds.

.112 Retroactive adjustments should be made to reflect accumulated depreciation as of the date an organization adopts this statement of position. For this purpose, the determination of asset lives should be based on a combination of the period from acquisition to the adoption date, plus estimated remaining life based on the current condition and planned use of the assets. When an organization records fixed assets using one of the "current value" methods referred to in paragraph .105, it is not necessary to disclose accumulated depreciation that would have been recorded had cost-based data been available.

Collections

.113 The accounting standards division considered at length the desirability of capitalizing (but not depreciating) the inexhaustible collections owned by museums, art galleries, botanical gardens, libraries, and similar entities. In view of the steward-

ship of those organizations to the public, it is desirable to catalogue and control the collections. Some believe that it is also desirable to present values for the collections on the organizations' balance sheets, since those values usually represent the largest assets of the organizations. The division has concluded that it is often impracticable to determine a value for such collections and accordingly has concluded that they need not be capitalized. If records and values do exist for the collections, the division encourages capitalization, at cost, if purchased, and at a fair value, if acquired by donation. If historical cost is indeterminable, the alternative methods of valuing described in the section on fixed assets should be used. If such collections are not capitalized, the caption "collections" should appear on the balance sheet with no amount shown but with a reference to a note that describes the collections.

.114 The nature and the cost or contributed value of current-period accessions and the nature of and proceeds from deaccessions should be disclosed in the financial statements.

.115 Collections that are exhaustible, such as exhibits with a limited display life, and that have been capitalized should be amortized over their useful lives.

Investment Pools

.116 To obtain investment flexibility, nonprofit organizations frequently pool investments of various funds. Inasmuch as the realized and unrealized gains or losses and income of specific investments cannot be identified with the specific funds participating in the pool, realized and unrealized gains or losses and income should be allocated equitably. To accomplish an equitable allocation, investment pools should be operated using the "market value unit method." Under that method, each fund is assigned a number of units based on the relationship of the market value of all investments at the time of entry in the pool. Periodically, the pooled assets are valued and new unit values are calculated. The new unit value is used to determine the number of units to be allocated to new funds entering the pool or to calculate the equity of funds withdrawing from the pool. Investment pool income, gains, and losses should be allocated periodically to participating funds based on the number of units held by each fund during the period. Other methods based on market value, including percentage participation, may also accomplish the same result.

.117 Pooled investments may include investments *carried at other than market value* even though, as indicated in paragraph .116, the pool itself must be operated on the basis of market value. Differences may exist between the carrying amounts of assets and fund balances withdrawn from the investment pool. Such differences should be allocated to the participating funds remaining in the pool in the same manner as income, gains, and losses. Alternatively, such adjustments could be reported separately from the carrying amount of specific investments or the fund balances of funds remaining in the pool.

Interfund Borrowings

.118 A governing board may sometimes authorize borrowings from restricted, endowment, or plant funds. The organization should determine if interest should be accrued. Interfund borrowings should be considered permanent and recorded as transfers when it becomes evident that contemplated sources of funds for repayment are not readily available. There may be legal prohibitions against lending such funds and against recording such transfers. If so, appropriate disclosure should be made.

.119 Material interfund borrowings should be disclosed when restricted funds have been loaned or when the liquidity of either fund is in question. If summary financial information is presented for a prior period, similar disclosure should be made.

Designations of Fund Balances

.120 The governing board of an organization may designate a portion of an unrestricted fund balance for a specific purpose. The designation is proper to the board's managerial function. However, such designations of fund balances are not expenses and should not be shown as such in the statement of activity. (See examples of designations in the Illustrative Financial Statements, Appendix C.)

Other Funds

.121 Donors frequently make gifts of future interests. The present value of the actuarially determined liability resulting from an annuity gift should be recorded at the date of the gift. The excess (or deficiency) in the amount of the annuity gift over the liability should be recorded as support in the year of the gift if it may be used immediately for the general purposes of the organization; in other instances, the excess should be reported as deferred revenue if restricted for specific purposes.

The principal amount of life income gifts, in which the donor reserves the right to the income generated from the gift for life or some other stipulated period of time, should also be recorded as deferred support in the balance sheet in the period the gift is received. The amount previously recorded as deferred support should be reflected as support or a capital addition at the future date when the terms of the annuity or life income gifts have been met.

.122 Funds that are held in trust by others under a legal trust instrument created by a donor independently of the reporting organization and that are neither in the possession nor under the control of the organization but are held and administered by outside fiscal agents with the organization deriving income from such funds should not be included in the balance sheet with funds administered by the organization. The funds contemplated by this paragraph are those of which the reporting organization is not the remainderman in the trust. Their existence should be disclosed either parenthetically in the endowment funds group in the balance sheet or in the notes to the financial statements. Significant income from such trusts should be reported separately.

.123 Certain organizations have customarily used other fund groups not specifically mentioned in this statement. Those fund groups are used to account for resources relating to activities such as agency or custodial relationships, self-administered pensions, and permanent maintenance funds. Such fund groups are frequently useful and informative and, therefore, may be reported separately in the financial statements. Alternatively, those funds may be combined with other similar fund groups to simplify statement presentation. In either case, the accountability for the fund group should be classified according to the exact nature of the funds involved, so that balances that are liabilities (such as agency, custodial, and self-administered pension funds) are distinguished from those that are fund balances (such as permanent maintenance funds). If there are true fund balances, changes in the balances should be accounted for in the statement of activity. The restricted nature of such funds should also be disclosed.

TRANSITION

.124 The accounting standards division recognizes that the Financial Accounting Standards Board presently has on its agenda a project on "Objectives of Financial Reporting by Non-

business Organizations.” The results of that project may affect financial reporting by the entities covered by this statement of position. On completion of that project, any recommendations in this statement of position that conflict with the FASB’s conclusions would need to be changed. Accordingly, the division has concluded that the principles contained in this statement of position need not be adopted until after the Financial Accounting Standards Board completes its project. At that time, a specific date on which the adoption of these principles is recommended will be announced. Organizations may voluntarily adopt these principles.

.125 Organizations that adopt the conclusions of this statement of position should apply them retroactively by prior-period adjustments. If financial statements for periods prior to adoption are not presented, the conclusions of the statement of position should be applied by adjusting opening fund balances for the initial application period. When financial statements for periods prior to adoption are presented, they should be restated to reflect the prior-period adjustments. The nature of the restatements and their effects should be disclosed in the period of change.

APPENDIX A

.126 Glossary

A number of terms used throughout this document are commonly used by nonprofit organizations and, because these terms have specialized meaning, this glossary is included.

accessions Additions, both purchased and donated, to collections held by museums, art galleries, botanical gardens, libraries, and similar entities.

agency fund *See* custodian funds.

annuity gift A gift of money or other property given to an organization on the condition that the organization bind itself to make periodic stipulated payments that terminate at a specified time to the donor or other designated individuals.

auxiliary activity An activity providing a service that is not part of the basic program services of the organization. A fee is normally charged that is directly related to, although not necessarily equal to, the cost of the service.

capital additions Gifts, grants, bequests, investment income, and gains and losses on investments restricted either permanently or for a period of time by parties outside of the organi-

zation to endowment and loan funds. Capital additions also include similar resources restricted for fixed asset additions but only to the extent expended during the year.

collections Works of art, botanical and animal specimens, books, and other items held for display or study by museums and similar institutions.

custodian funds Funds received and held by an organization as fiscal agent for others.

deaccessions Dispositions of items in collections held by museums, art galleries, botanical gardens, libraries, and similar entities.

deferred capital additions Capital additions received or recorded before the related restrictions are met. *See also* capital additions.

deferred revenue and support Revenue or support received or recorded before it is earned, that is, before the conditions are met, in whole or in part, for which the revenue or support is received or is to be received.

designated funds Unrestricted funds set aside for specific purposes by action of the governing board. *See also* quasi-endowment funds.

encumbrances Commitments in the form of orders, contracts, and similar items that will become payable when goods are delivered or services rendered.

endowment fund A fund in which a donor has stipulated in the donative instrument that the principal is to be maintained inviolate and in perpetuity and only the income from the investments of the fund may be expended. *See also* term endowment.

expendable funds Funds that are available to finance an organization's program and supporting services, including both unrestricted and restricted amounts.

functional classification A classification of expenses that accumulates expenses according to the purpose for which costs are incurred. The primary functional classifications are program and supporting services.

fund An accounting entity established for the purpose of accounting for resources used for specific activities or objectives in accordance with special regulations, restrictions, or limitations.

fund group A group of funds of similar character, for example, operating funds, endowment funds, and annuity and life income funds.

funds held in trust by others Resources held and administered, at the direction of the donor, by an outside trustee for the benefit of the organization.

investment pool Assets of several funds pooled or consolidated for investment purposes.

life income agreement An agreement whereby money or other property is given to an organization on the condition that the organization bind itself to pay periodically to the donor or other designated individual the income earned by the assets donated to the organization for the lifetime of the donor or of the designated individual.

loan funds Resources restricted for loans. When both principal and interest on the loan funds received by the organization are loanable, they are included in the loan-fund group. If only the income from a fund is loanable, the principal is included in endowment funds, while the cumulative income constitutes the loan fund.

natural expense classification *See* object classification of expenses.

net investment in plant The total carrying value of all property, plant, equipment, and related liabilities, exclusive of those real properties that are held for investment.

nonexpendable additions *See* capital additions.

object classification of expenses A method of classifying expenditures according to their natural classification, such as salaries and wages, employee benefits, supplies, purchased services, and so forth.

pledge A promise to make a contribution to an organization in the amount and form stipulated.

quasi-endowment funds Funds that the governing board of an organization, rather than a donor or other outside agency, has determined are to be retained and invested. The governing board has the right to decide at any time to expend the principal of such funds. *See also* designated funds.

restricted funds Funds whose use is restricted by outside agencies or persons as contrasted with funds over which the organization has complete control and discretion.

revenues Gross increases in assets, gross decreases in liabilities, or a combination of both from delivering or producing goods, rendering services, or other earning activities of an organization during a period, for example, dues, sale of services, ticket sales, fees, interest, dividends, and rent.

support The conveyance of property from one person or organization to another without consideration, for example, donations, gifts, grants, or bequests.

term endowment A fund that has all the characteristics of an endowment fund, except that at some future date or event it will no longer be required to be maintained as an endowment fund.

transfer Moving fund balances from one fund to another, usually as a result of an intended change in the use of assets.

unrestricted funds Funds that have no external restriction on their use or purpose, that is, funds that can be used for any purpose designated by the governing board as distinguished from funds restricted externally for specific purposes (for example, for operations, plant, and endowment).

APPENDIX B

.127 Illustrative Allocation Procedures Under Paragraph .100

Although the following allocation procedures are illustrative only, using them or similar procedures ordinarily results in a reasonable allocation of an organization's multiple function expenses:

- A study of the organization's activities may be made at the start of each fiscal year to determine the best practicable allocation methods. The study should include an evaluation of the preceding year's time records or activity reports of key personnel, the use of space, the consumption of supplies and postage, and so forth. The results of the study should be reviewed periodically, and the allocation methods should be revised, if necessary, to reflect significant changes in the nature or level of the organization's current activities.
- Periodic time and expense records may be kept by employees who spend time on more than one function as a basis for allocating salaries and related costs. The records should indicate the nature of the activities in which the employee is involved. If the functions do not vary significantly from period to pe-

riod, the preparation of time reports for selected test periods during the year might be sufficient.

- Automobile and travel costs may be allocated on the basis of the expense or time reports of the employees involved.
- Telephone expense may be allocated on the basis of use by extensions, generally following the charge assigned to the salary of the employee using the telephone, after making direct charges for the toll calls or other service attributable to specific functions.
- Stationery, supplies, and postage costs may be allocated based on a study of their use.
- Occupancy costs may be allocated on the basis of a factor determined from a study of the function of the personnel using the space involved.
- Depreciation and rental of equipment may be allocated based on asset usage.

APPENDIX C

.128 Illustrative Financial Statements

The following illustrative financial statements (exhibits 1 through 13) demonstrate the practical applications of the reporting practices discussed in this statement of position. Specific types of nonprofit organizations have been selected to illustrate a wide diversity of reporting practices; it is not intended that these illustrations represent either the only types of disclosure or the only statement formats that would be appropriate. Nonprofit organizations are urged to develop financial statement formats that are appropriate for their individual circumstances while being consistent with the accounting and reporting practices discussed in this document.

The notes to the financial statements in exhibit 1 are representative of the basic types of disclosure a typical nonprofit organization would include in its financial report. To avoid unnecessary repetition, the notes to the financial statements of exhibits 2 through 13 have been condensed to indicate only major topics of disclosure, except in those instances in which it is appropriate to include additional items that are unique to a particular type of nonprofit organization.

For conciseness, only some of the sample financial statements have been presented in comparative format. As noted in the text of the statement, the division encourages the presentation of comparative statements.

Index to Illustrative Financial Statements

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EXHIBIT 1—INDEPENDENT SCHOOL

EXHIBIT 1A

Sample Independent School

Balance Sheet

June 30, 19X1

	<i>Operating Funds</i>	<i>Plant Funds</i>	<i>Endowment Funds</i>	<i>Total All Funds</i>
Assets				
Cash	\$ 87,000	\$ 15,000	\$ 19,000	\$ 121,000
Accounts receivable, less allowance for doubtful receivables of \$3,000	34,000	—	—	34,000
Pledges receivable, less allowance for doubtful pledges of \$10,000	—	75,000	—	75,000
Inventories, at lower of cost (FIFO) or market	7,000	—	—	7,000
Investments (Note 2)	355,000	10,000	100,000	465,000
Land, buildings, equipment, and library books, at cost less accumulated depreciation of \$980,000 (Note 3)	—	2,282,000	—	2,282,000
Other assets	17,000	—	—	17,000
Total assets	<u>\$500,000</u>	<u>\$2,382,000</u>	<u>\$119,000</u>	<u>\$3,001,000</u>
Liabilities and Fund Balances				
Accounts payable and accrued expenses	\$ 13,000	—	—	\$ 13,000
Deferred amounts (Note 6)				
Unrestricted	86,000	—	—	86,000
Restricted	27,000	\$ 100,000	—	127,000
Long-term debt (Note 4)	—	131,000	—	131,000
Total liabilities	<u>126,000</u>	<u>231,000</u>	<u>—</u>	<u>357,000</u>
Fund balances				
Unrestricted				
Designated by the governing board for long-term investment	355,000	—	—	355,000
Undesignated	19,000	—	—	19,000
	<u>374,000</u>	<u>—</u>	<u>—</u>	<u>374,000</u>
Restricted—nonexpendable	—	—	\$119,000	119,000
Net investment in plant	—	2,151,000	—	2,151,000
Total fund balances	<u>374,000</u>	<u>2,151,000</u>	<u>119,000</u>	<u>2,644,000</u>
Total liabilities and fund balances	<u>\$500,000</u>	<u>\$2,382,000</u>	<u>\$119,000</u>	<u>\$3,001,000</u>

EXHIBIT 1B
Sample Independent School
Statement of Support and Revenue, Expenses,
Capital Additions, and Changes in Fund Balances
Year Ended June 30, 19X1

	Operating Funds	Total	Plant Funds	Endowment Funds	Total All Funds
	Unrestricted	Restricted			
Support and revenue					
Tuition and fees	\$ 910,000	—	—	—	\$ 910,000
Contributions	104,000	\$80,500	—	—	184,500
Endowment and other investment income	23,000	1,500	—	—	24,500
Net loss on investment transactions	(8,000)	—	—	—	(8,000)
Auxiliary activities	25,000	—	—	—	25,000
Summer school and other programs	86,000	—	—	—	86,000
Other sources	26,000	—	—	—	26,000
Total support and revenue	<u>1,166,000</u>	<u>82,000</u>	<u>—</u>	<u>—</u>	<u>1,248,000</u>
Expenses					
Program services					
Instruction and student activities	798,000	43,000	\$ 69,000	—	910,000
Auxiliary activities	24,000	—	—	—	24,000
Summer school and other programs	91,000	—	7,000	—	98,000
Financial aid	—	37,000	3,000	—	40,000
Total program services	<u>913,000</u>	<u>80,000</u>	<u>79,000</u>	<u>—</u>	<u>1,072,000</u>

Supporting services	147,000	2,000	149,000	13,000	162,000
General administration	12,000	—	12,000	1,000	13,000
Fund raising	159,000	2,000	161,000	14,000	175,000
Total supporting services	1,072,000	82,000	1,154,000	93,000	1,247,000
Total expenses					
Excess (deficiency) of support and revenue over expenses before capital additions	94,000	—	94,000	(93,000)	1,000
Capital additions					
Contributions and bequests	—	—	—	80,000	110,000
Investment income	—	—	—	5,000	5,000
Net gain on investment transactions	—	—	—	1,000	3,000
Total capital additions	—	—	—	86,000	118,000
Excess (deficiency) of support and revenue over expenses after capital additions	94,000	—	94,000	(7,000)	119,000
Fund balances at beginning of year	387,000	—	387,000	2,047,000	2,525,000
Transfers					
Equipment acquisitions and principal debt service payments	(111,000)	—	(111,000)	111,000	—
Realized gains on endowment funds utilized	4,000	—	4,000	—	(4,000)
Fund balances at end of year	<u>\$ 374,000</u>	<u>—</u>	<u>\$ 374,000</u>	<u>\$ 2,151,000</u>	<u>\$ 2,644,000</u>

EXHIBIT 1C

Sample Independent School
Statement of Changes in Financial Position
Year Ended June 30, 19X1

	<u>Operating Funds</u>	<u>Plant Funds</u>	<u>Endowment Funds</u>	<u>Total All Funds</u>
Resources provided				
Excess (deficiency) of support and revenue over expenses before capital additions	\$ 94,000	\$ (93,000)	—	\$ 1,000
Capital additions				
Contributions and bequests	—	80,000	\$ 30,000	110,000
Investment income	—	5,000	—	5,000
Net gain on investments	—	1,000	2,000	3,000
Excess (deficiency) of support and revenue over expenses after capital additions	94,000	(7,000)	32,000	119,000
Items not using (providing) resources				
Provision for depreciation	—	93,000	—	93,000
Net (gain) loss on investment transactions	8,000	(1,000)	(2,000)	5,000
Decrease in inventories	2,000	—	—	2,000
Increase in deferred amounts	3,000	75,000	—	78,000
Proceeds from sale of investments	160,000	2,000	47,000	209,000
Total resources provided	<u>267,000</u>	<u>162,000</u>	<u>77,000</u>	<u>506,000</u>
Resources used				
Purchases of equipment	—	145,000	—	145,000
Reduction of long-term debt	—	52,000	—	52,000
Purchases of investments	210,000	6,000	136,000	352,000
Increase in other assets	1,000	—	—	1,000
Increase in accounts and pledges receivable	3,000	60,000	—	63,000
Decrease in accounts payable and accrued expenses	3,000	—	—	3,000
Total resources used	<u>217,000</u>	<u>263,000</u>	<u>136,000</u>	<u>616,000</u>
Transfers				
Equipment acquisitions and principal debt service payments	(111,000)	111,000	—	—
Realized gains on endowment funds utilized	4,000	—	(4,000)	—
Total transfers	<u>(107,000)</u>	<u>111,000</u>	<u>(4,000)</u>	<u>—</u>
Increase (decrease) in cash	<u>\$ (57,000)</u>	<u>\$ 10,000</u>	<u>\$ (63,000)</u>	<u>\$ (110,000)</u>

EXHIBIT 1D

Sample Independent School
Notes to Financial Statements
Year Ended June 30, 19X1

Note 1—Summary of Significant Accounting Policies

The financial statements of Sample Independent School have been prepared on the accrual basis. The significant accounting policies followed are described below to enhance the usefulness of the financial statements to the reader.

Fund Accounting

To ensure observance of limitations and restrictions placed on the use of resources available to the school, the accounts of the school are maintained in accordance with the principles of fund accounting. This is the procedure by which resources for various purposes are classified for accounting and reporting purposes into funds established according to their nature and purposes. Separate accounts are maintained for each fund, however, in the accompanying financial statements, funds that have similar characteristics have been combined into fund groups. Accordingly, all financial transactions have been recorded and reported by fund group.

The assets, liabilities, and fund balances of the school are reported in three self-balancing fund groups as follows:

- Operating funds, which include unrestricted and restricted resources, represent the portion of expendable funds that is available for support of school operations.
- Plant funds represent resources restricted for plant acquisitions and funds expended for plant.
- Endowment funds represent funds that are subject to restrictions of gift instruments requiring in perpetuity that the principal be invested and the income only be used.

Expendable Restricted Resources

Operating and plant funds restricted by the donor, grantor, or other outside party for particular operating purposes or for plant acquisitions are deemed to be earned and reported as revenues of operating funds or as additions to plant funds, respectively, when the school has incurred expenditures in compliance with the specific restrictions. Such amounts received but not yet earned are reported as restricted deferred amounts.

Plant Assets and Depreciation

Uses of operating funds for plant acquisitions and principal debt service payments are accounted for as transfers to plant funds. Proceeds from the sale of plant assets, if unrestricted, are transferred to operating fund balances, or, if restricted, to deferred amounts restricted for plant acquisitions. Depreciation of buildings and equipment is provided over the estimated useful lives of the respective assets on a straight-line basis.

Other Matters

All gains and losses arising from the sale, collection, or other disposition of investments and other noncash assets are accounted for in the fund that owned the assets. Ordinary income from investments, receivables, and the like is accounted for in the fund owning the assets, except for income derived from investments of endowment funds, which is accounted for, if unrestricted, as revenue of the expendable operating fund or, if restricted, as deferred amounts until the terms of the restriction have been met

Legally enforceable pledges less an allowance for uncollectible amounts are recorded as receivables in the year made. Pledges for support of current operations are recorded as operating fund support. Pledges for support of future operations and plant acquisitions are recorded as deferred amounts in the respective funds to which they apply.

Note 2—Investments

Investments are presented in the financial statements in the aggregate at the lower of cost (amortized, in the case of bonds) or fair market value

	<u>Cost</u>	<u>Market</u>
Operating funds	\$355,000	\$365,000
Plant funds	10,000	11,000
Endowment funds	<u>100,000</u>	<u>109,000</u>
	<u>\$465,000</u>	<u>\$485,000</u>

Investments are composed of the following:

	<u>Cost</u>	<u>Market</u>
Corporate stocks and bonds	\$318,000	\$320,000
U.S. government obligations	141,000	159,000
Municipal bonds	<u>6,000</u>	<u>6,000</u>
	<u>\$465,000</u>	<u>\$485,000</u>

The following tabulation summarizes the relationship between carrying values and market values of investment assets.

	<u>Carrying Value</u>	<u>Market Value</u>	<u>Excess of Market Over Cost</u>
Balance at end of year	<u>\$465,000</u>	<u>\$485,000</u>	\$ 20,000
Balance at beginning of year	<u>\$327,000</u>	<u>\$335,000</u>	<u>8,000</u>
Increase in unrealized appreciation			12,000
Realized net loss for year			<u>(5,000)</u>
Total net gain for year			<u>\$ 7,000</u>

The average annual yield exclusive of net gains (losses) was 7% and the annual total return based on market value was 9% for the year ended June 30, 19X1.

Note 3—Plant Assets and Depreciation

A summary of plant assets follows.

Land	\$ 255,000
Buildings	2,552,000
Equipment	340,000
Library books	<u>115,000</u>
	3,262,000
Less accumulated depreciation	<u>980,000</u>
	<u><u>\$2,282,000</u></u>

Note 4—Long-Term Debt

A summary of long-term debt follows.

7½% unsecured notes payable to bank due in quarterly installments of \$2,500	\$ 29,000
8½% mortgage payable in semiannual installments of \$3,500 through 19X7	<u>102,000</u>
	<u><u>\$131,000</u></u>

Note 5—Pension Plans

The school has noncontributory pension plans covering all personnel. Total pension expense for the year ended June 30, 19X1, was \$60,000, which includes amortization of prior service costs over a period of twenty years. The school's policy is to fund pension costs accrued. The actuarially computed value of vested benefits as of June 30, 19X1, exceeds net assets of the pension fund by approximately \$100,000.

Note 6—Changes in Deferred Restricted Amounts

	<i>Operating Funds</i>	<i>Plant Fund</i>
Balances at beginning of year	\$ 24,000	\$ 25,000
Additions		
Contributions and bequests	79,000	158,000
Investment income	6,000	1,000
Net gain on investment transactions	<u>—</u>	<u>2,000</u>
	109,000	186,000
Deductions—funds expended during the year	<u>82,000</u>	<u>86,000</u>
Balances at end of year	<u><u>\$ 27,000</u></u>	<u><u>\$100,000</u></u>

Note 7—Functional Allocation of Expenses

The costs of providing the various programs and other activities have been summarized on a functional basis in the statement of support and rev-

enue, expenses, capital additions, and changes in fund balances. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Note 8—Commitments

The school has entered into various agreements aggregating approximately \$80,000 for the purchase of equipment to be received subsequent to June 30, 19X1.

.130 EXHIBIT 2—CEMETERY ORGANIZATION

EXHIBIT 2A
Sample Cemetery Organization
Balance Sheet
June 30, 19X1, and 19X0

	19X1	19X0	Liabilities and Fund Balance	19X1	19X0
Assets					
Current			Current		
Cash	\$ 47,000	\$ 27,000	Accounts payable	\$ 90,000	\$ 41,000
Receivables, net	15,000	15,000	Accrued expenses	12,000	8,000
Inventory of supplies	55,000	46,000	Portion of long-term debt currently due	30,000	30,000
Prepaid expenses	4,000	3,000	Total current liabilities	132,000	79,000
Total current assets	121,000	91,000	Long-term debt (Note 4)	240,000	270,000
Inventory					
Investment in real estate	370,000	370,000			
Space development	197,000	110,000			
Total inventory	567,000	480,000			
Property plant, and equipment at cost (Note 2)			Fund balance	404,000	397,000
Land, other than burial spaces	125,000	125,000			
Buildings	105,000	105,000			
Equipment	75,000	70,000			
Less accumulated depreciation	305,000	300,000			
Fixed assets net	217,000	125,000			
Total	88,000	175,000			
	\$776,000	\$746,000	Total	\$776,000	\$746,000

EXHIBIT 2B

Sample Cemetery Organization
Statement of Revenue and Expenses
Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Revenue		
Net sales		
Spaces	\$210,000	\$201,000
Memorials and inscriptions	36,000	30,000
Interment fees	20,000	14,000
Other fees	<u>6,000</u>	<u>2,000</u>
Total	<u>272,000</u>	<u>247,000</u>
Cost of sales		
Spaces	150,000	151,000
Memorials	19,000	14,000
Burial services	<u>16,000</u>	<u>13,000</u>
Total	<u>185,000</u>	<u>178,000</u>
Gross margin	<u>87,000</u>	<u>69,000</u>
Expenses		
Maintenance	60,000	50,000
General administration	30,000	18,000
Commissions	<u>10,000</u>	<u>9,000</u>
Total	<u>100,000</u>	<u>77,000</u>
Operating margin	(13,000)	(8,000)
Other revenue		
Income from care and maintenance funds (Note 3)	<u>20,000</u>	<u>13,000</u>
Excess of revenue over expenses	7,000	5,000
Fund balance—beginning	<u>397,000</u>	<u>392,000</u>
Fund balance—ending	<u>\$404,000</u>	<u>\$397,000</u>

EXHIBIT 2C

Sample Cemetery Organization
Statement of Changes in Financial Position
Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Source of cash		
Excess of revenue over expenses	\$ 7,000	\$ 5,000
Charges not requiring (providing) cash in the current period—depreciation and amortization	<u>92,000</u>	<u>74,000</u>
Cash provided from operations	99,000	79,000
Increases in accounts payable and accrued expenses	<u>53,000</u>	<u>14,000</u>
Total sources of cash	<u>152,000</u>	<u>93,000</u>
Uses of cash		
Space development and equipment	92,000	40,000
Increase in accounts receivable	—	15,000
Reduction of long-term debt	30,000	30,000
Increase in supplies and prepaid expenses	<u>10,000</u>	<u>2,000</u>
Total uses of cash	<u>132,000</u>	<u>87,000</u>
Increases in cash	20,000	6,000
Cash, beginning of year	<u>27,000</u>	<u>21,000</u>
Cash, end of year	<u>\$ 47,000</u>	<u>\$ 27,000</u>

EXHIBIT 2D

Sample Cemetery Organization**Notes to Financial Statements*****June 30, 19X1, and 19X0****Note 1—Summary of Significant Accounting Policies**

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Revenue Recognition

Sales of spaces are recorded when contracts of sales are signed.

Cost of Spaces Sold

The cost of each space sold is computed based on allocation of total expenses incurred in developing the cemetery.

Note 2—Property, Plant, and Equipment**Note 3—Maintenance Funds***General Maintenance*

Under the State Cemetery Act, Sample Cemetery is required, among other things, to collect and pay into a general maintenance fund the following fees and charges.

Fifteen percent (15%) of the gross sales price of each plot sold.

Ten dollars (\$10) for each interment

Five cents (\$.05) per square unit of surface area of the base of a memorial.

The general maintenance fund principal is restricted by the State Cemetery Act for major improvements and repairs and, accordingly, is not included in the financial statements. At June 30, 19X1, and 19X0 this fund amounted to \$383,000 and \$338,000, respectively. Investment income is unrestricted and is included in other income.

Specific Trusts

Specific trust funds are restricted for flowers, seeding, sodding, and other maintenance of the specific plots as prescribed by the external source and are not available for general use by the cemetery. During the years ended

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

June 30, 19X1, and June 30, 19X0, \$11,000 and \$2,000, respectively, were expended for specific trust maintenance and have been reflected in the statement of revenue and expense.

Note 4—Long-Term Debt

Note 5—Functional Allocation of Expenses

Note 6—Commitments

EXHIBIT 3—COUNTRY CLUB

EXHIBIT 3A
Sample Country Club
Balance Sheet
March 31, 19X1, and 19X0

	19X1	19X0
Assets		
Current assets		
Cash	\$ 44,413	\$ 37,812
Investments (Note 2)	289,554	388,007
Accounts receivable, less allowances of \$5,000 in 19X1, and \$6,000 in 19X0	71,831	45,898
Inventories, at lower of cost (FIFO) or market	27,930	28,137
Prepaid expenses	19,154	13,948
Total current assets	452,882	513,802
Property and equipment, at cost (Note 3)		
Land and land improvements	1,085,319	1,098,828
Buildings	1,331,590	1,200,585
Furniture, fixtures, and equipment	274,761	254,540
	2,691,670	2,553,953
Less accumulated depreciation	864,564	824,088
	1,827,106	1,729,865
Other assets		
Deferred charges	15,077	16,524
Beverage license	10,500	10,500
	25,577	27,024
	\$2,305,565	\$2,270,691
Liabilities and Membership Equity		
Current liabilities		
Accounts payable and accrued expenses	\$ 61,426	\$ 63,600
Deferred revenues—initiation fees (Note 1)	15,677	7,755
Due to resigned members	16,400	12,900
Taxes	20,330	23,668
Total current liabilities	113,833	107,923
Membership equity		
Proprietary certificates, 500 at \$1,500 each— no change during the years	750,000	750,000
Cumulative excess of revenue over expenses	1,441,732	1,412,768
	2,191,732	2,162,768
	\$2,305,565	\$2,270,691

EXHIBIT 3B

Sample Country Club**Statement of Revenue, Expenses, and Changes in
Cumulative Excess of Revenue Over Expenses
Years Ended March 31, 19X1, and 19X0**

	<u>19X1</u>	<u>19X0</u>
Revenue		
Dues	\$ 590,000	\$ 600,000
Restaurant and bar charges	270,412	265,042
Greens fees	171,509	163,200
Tennis and swimming fees	83,829	67,675
Initiation fees	61,475	95,220
Locker and room rentals	49,759	49,954
Interest and discounts	28,860	28,831
Golf cart rentals	26,584	24,999
Other—net	4,011	3,893
Total revenue	<u>1,286,439</u>	<u>1,298,814</u>
Expenses		
Greens	241,867	244,823
House	212,880	210,952
Restaurant and bar	153,035	136,707
Tennis and swimming	67,402	48,726
General and administrative	533,838	690,551
Net (gains) losses on investments	98,453	(98,813)
Total expenses	<u>1,307,475</u>	<u>1,232,946</u>
Excess (deficiency) of revenue over expenses before capital additions	(21,036)	65,868
Capital additions		
Assessments for capital improvements	50,000	—
Excess (deficiency) of revenue over expenses after capital additions	28,964	65,868
Cumulative excess of revenue over expenses— beginning of year	<u>1,412,768</u>	<u>1,346,900</u>
Cumulative excess of revenue over expenses—end of year	<u>\$1,441,732</u>	<u>\$1,412,768</u>

Statements of Position

EXHIBIT 3C

Sample Country Club**Statement of Changes in Financial Position**
Years Ended March 31, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Sources of funds		
Excess (deficiency) of revenue over expenses before capital additions	\$ (21,036)	\$ 65,868
Capital additions	<u>50,000</u>	<u>—</u>
Excess (deficiency) of revenue over expenses after capital additions	28,964	65,868
Add-back provision for depreciation, which does not affect working capital	<u>40,476</u>	<u>61,618</u>
Total from operations	69,440	127,486
Decrease in deferred charges—net	<u>1,447</u>	<u>—</u>
Total sources	<u>70,887</u>	<u>127,486</u>
Applications of funds		
Purchases of property and equipment	137,717	84,377
Increase in deferred charges—net	<u>—</u>	<u>8,909</u>
Total applications	<u>137,717</u>	<u>93,286</u>
Increase (decrease) in working capital	<u>\$ (66,830)</u>	<u>\$ 34,200</u>
Changes in the components of working capital are summarized as follows		
Increase (decrease) in current assets		
Cash	\$ 6,601	\$ (70,928)
Investments	(98,453)	98,813
Accounts receivable	25,933	5,000
Inventories	(207)	8,112
Prepaid expenses	<u>5,206</u>	<u>2,056</u>
	<u>(60,920)</u>	<u>43,053</u>
(Increase) decrease in current liabilities		
Accounts payable and accrued expenses	2,174	(5,597)
Deferred revenues—initiation fees	(7,922)	(3,517)
Due to resigned members	(3,500)	(2,700)
Taxes	<u>3,338</u>	<u>2,961</u>
	<u>(5,910)</u>	<u>(8,853)</u>
Increase (decrease) in working capital	<u>\$ (66,830)</u>	<u>\$ 34,200</u>

EXHIBIT 3D

Sample Country Club
Notes to Financial Statements*
March 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Principles

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Membership Dues and Initiation Fees

Membership dues are recognized as revenue in the applicable membership period. Initiation fees are recorded as revenue in the period when the fees are due.

Note 2—Investments

Note 3—Property and Equipment and Depreciation

Note 4—Pension Plans

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 4—LIBRARY

EXHIBIT 4A

**Sample Library
Balance Sheet**

**December 31, 19X1
(With Comparative Totals for 19X0)**

	December 31, 19X1			December 31, 19X0	
	Unrestricted	Current Restricted	Plant	Endowment	Total
	Operating Investment	Total	Restricted	Total	Total
\$ 690,000	\$ 690,000	\$ 3,000	\$ 7,000	—	\$ 700,000
375,000	375,000	75,000	—	—	450,000
120,000	120,000	—	—	—	120,000
30,000	30,000	27,000	8,000	—	65,000
15,000	15,000	—	—	—	15,000
70,000	70,000	—	—	—	70,000
1,300,000	1,300,000	105,000	15,000	—	1,420,000
—	920,000	—	165,000	\$985,000	2,070,000
—	—	—	1,525,000	—	1,525,000
—	—	—	—	—	—
<u>\$1,300,000</u>	<u>\$2,220,000</u>	<u>\$105,000</u>	<u>\$1,705,000</u>	<u>\$985,000</u>	<u>\$5,015,000</u>
					<u>\$4,895,000</u>

Assets

Current assets
 Cash, including interest-bearing accounts of \$600,000 in 19X1, and \$400,000 in 19X0
 Certificates of deposit
 Grants receivable (Note 1)
 Governments
 Other
 Pledges receivable, at estimated net realizable value (Note 1)
 Prepaid expenses and other current assets
 Total current assets
 Investments—at market (Note 2)
 Land, buildings, and equipment—at cost, less accumulated depreciation of \$90,000 and \$79,000, respectively (Note 3)
 Inexhaustible collections and books (Note 1)
 Total assets

Liabilities and Fund Balances

Current liabilities										
Accounts payable, accrued expenses, and current portion of long-term debt	\$ 200,000	—	\$ 200,000	—	\$ 10,000	—	\$ 210,000	\$ 130,000		
Deferred restricted contributions, etc (Note 6)	—	—	—	\$105,000	5,000	—	110,000	100,000		
Total current liabilities	200,000	—	200,000	105,000	15,000	—	320,000	230,000		
Long-term debt (Note 4)	—	—	—	—	180,000	—	180,000	190,000		
Total liabilities	200,000	—	200,000	105,000	195,000	—	500,000	420,000		
Fund balances										
Unrestricted										
Designated by the board for										
Investment	—	\$920,000	920,000	—	—	—	920,000	740,000		
Purchase of equipment	50,000	—	50,000	—	—	—	50,000	35,000		
Undesignated	1,050,000	—	1,050,000	—	1,510,000	—	2,560,000	2,725,000		
Restricted	—	—	—	—	—	\$985,000	985,000	975,000		
Total fund balances	1,100,000	920,000	2,020,000	—	1,510,000	985,000	4,515,000	4,475,000		
Total liabilities and fund balances	\$1,300,000	\$920,000	\$2,220,000	\$105,000	\$1,705,000	\$985,000	\$5,015,000	\$4,895,000		

EXHIBIT 4B
Sample Library
Statement of Support, Revenue, and Expenses and Changes in Fund Balances
Year Ended December 31, 19X1
(With Comparative Totals for 19X0)

	Year Ended December 31				Year Ended December 31, 19X0
	19X1		19X0		
	Unrestricted	Current Restricted	Plant	Endowment		Total
Support and revenue					
Support					
Grants (Note 1)	\$ 150,000	—	—	—	\$ 150,000
Governments	25,000	—	—	—	25,000
Other	—	—	—	—	—
Contributions, legacies, and bequests (Note 1)	350,000	\$ 90,000	—	—	515,000
Contributed services of volunteers (Note 1)	75,000	—	—	—	75,000
Use of contributed facilities (Note 1)	47,000	—	—	—	47,000
Total support	647,000	90,000	737,000	75,000	812,000
Revenue					
Fees for services	50,000	—	—	—	50,000
Book rentals and fines	320,000	—	—	—	320,000
Investment income including net gains	25,000	93,000	118,000	10,000	128,000
Total revenue	395,000	93,000	488,000	10,000	498,000
Total support and revenue	1,042,000	183,000	1,225,000	85,000	1,310,000
					740,000

Expenses (Note 7)												
Program services												
Circulating library	390,000	—	390,000	75,000	\$ 5,000	—	—	—	—	470,000	—	430,000
Research library	169,000	—	169,000	—	1,000	—	—	—	—	170,000	—	155,000
Collections and exhibits	49,000	—	49,000	10,000	1,000	—	—	—	—	60,000	—	50,000
Educational services	49,000	—	49,000	—	1,000	—	—	—	—	50,000	—	55,000
Community services	29,500	—	29,500	—	500	—	—	—	—	30,000	—	20,000
Total program services	<u>686,500</u>	<u>—</u>	<u>686,500</u>	<u>85,000</u>	<u>8,500</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>780,000</u>	<u>—</u>	<u>710,000</u>
Supporting services												
General administration	315,500	3,000	318,500	—	21,500	—	—	—	—	340,000	—	290,000
Fund raising	200,000	—	200,000	—	5,000	—	—	—	—	205,000	—	200,000
Total supporting services	<u>515,500</u>	<u>3,000</u>	<u>518,500</u>	<u>—</u>	<u>26,500</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>545,000</u>	<u>—</u>	<u>490,000</u>
Total expenses	<u>1,202,000</u>	<u>3,000</u>	<u>1,205,000</u>	<u>85,000</u>	<u>35,000</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>1,325,000</u>	<u>—</u>	<u>1,200,000</u>
Excess (deficiency) of support and revenue over expenses before capital additions	<u>(160,000)</u>	<u>180,000</u>	<u>20,000</u>	<u>—</u>	<u>(35,000)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(15,000)</u>	<u>—</u>	<u>(62,000)</u>
Capital additions												
Contributions	—	—	—	—	40,000	—	—	—	—	40,000	—	95,000
Investment income including net gains	—	—	—	—	5,000	—	—	—	—	5,000	—	17,000
Contributed materials, equipment, etc (Note 1)	—	—	—	—	10,000	—	—	—	—	10,000	—	—
Total capital additions	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>55,000</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>55,000</u>	<u>—</u>	<u>112,000</u>
Excess (deficiency) of support and revenue over expenses after capital additions	<u>(160,000)</u>	<u>180,000</u>	<u>20,000</u>	<u>—</u>	<u>20,000</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>40,000</u>	<u>—</u>	<u>50,000</u>
Fund balances at beginning of year	1,270,000	740,000	2,010,000	—	1,480,000	\$985,000	—	—	—	4,475,000	—	4,425,000
Mandatory transfers—principal of indebtedness	(10,000)	—	(10,000)	—	10,000	—	—	—	—	—	—	—
Fund balances at end of year	<u>\$1,100,000</u>	<u>\$920,000</u>	<u>\$2,020,000</u>	<u>—</u>	<u>\$1,510,000</u>	<u>\$985,000</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>\$4,515,000</u>	<u>—</u>	<u>\$4,475,000</u>

EXHIBIT 4C
Sample Library
Statement of Changes in Financial Position
Year Ended December 31, 19X1 (With Comparative Totals for 19X0)

	Year Ended December 31, 19X1			Year Ended December 31, 19X0		
	Unrestricted	Total	Current Restricted	Plant	Total	Total
Sources of working capital						
Excess (deficiency) of support and revenue over expenses before capital additions	\$(160,000)	\$ 20,000	—	\$(35,000)	\$ (15,000)	\$ (62,000)
Capital additions	—	—	—	55,000	55,000	112,000
Excess (deficiency) of support and revenue over expenses after capital additions	(160,000)	20,000	—	20,000	40,000	50,000
Add (deduct) items not using (providing) working capital	—	—	—	11,000	11,000	11,000
Depreciation	—	—	—	(10,000)	(10,000)	—
Contributed equipment	—	—	—	21,000	41,000	61,000
Working capital provided by operations	—	20,000	—	—	41,000	61,000
Deferred restricted contributions and investment income received	22,000	267,000	\$85,000	—	85,000	100,000
Sale of investments	(138,000)	425,000	—	—	267,000	110,000
	(138,000)	425,000	85,000	21,000	393,000	271,000

Uses of working capital									
Purchase of investments				165,000	165,000			165,000	—
Purchase of fixed assets				35,000	35,000			35,000	35,000
Reduction of long-term debt				10,000	10,000			10,000	10,000
Deferred restricted contributions and investment income recognized as support			85,000	—	—	85,000		85,000	100,000
Transfers between funds	10,000	—	—	(10,000)	—	—		—	—
	10,000	—	85,000	200,000	295,000	—		295,000	145,000
	<u>\$ (148,000)</u>	<u>\$ 425,000</u>	<u>\$ 277,000</u>	<u>\$ (179,000)</u>	<u>\$ 98,000</u>	<u>\$ 98,000</u>		<u>\$ 98,000</u>	<u>\$ 126,000</u>
Increase (decrease) in working capital									
Changes in working capital components									
Increase (decrease) in current assets									
Cash	\$ (129,000)	\$ 425,000	\$ 296,000	\$ (7,000)	\$ (7,000)	\$ 289,000		\$ 289,000	\$ (5,000)
Certificates of deposit	22,000	—	22,000	20,000	20,000	(75,000)		(75,000)	61,000
Grants receivable	54,000	—	54,000	(8,000)	(8,000)	(11,000)		(11,000)	60,000
Pledges receivable	—	—	—	—	—	—		—	(5,000)
Prepaid expenses and other current assets	(15,000)	—	(15,000)	—	—	(15,000)		(15,000)	—
	(68,000)	425,000	357,000	5,000	(174,000)	188,000		188,000	111,000
(Increase) decrease in current liabilities									
Accounts payable, accrued expenses, and current portion of long-term debt	(80,000)	—	(80,000)	—	—	(80,000)		(80,000)	15,000
Deferred restricted contributions, etc.	—	—	—	(5,000)	(5,000)	(10,000)		(10,000)	—
	<u>\$ (148,000)</u>	<u>\$ 425,000</u>	<u>\$ 277,000</u>	<u>\$ (179,000)</u>	<u>\$ (179,000)</u>	<u>\$ 98,000</u>		<u>\$ 98,000</u>	<u>\$ 126,000</u>
Increase (decrease) in working capital									

EXHIBIT 4D

Sample Library
Notes to Financial Statements*
December 31, 19X1

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Contributed Facilities

The library occupies without charge certain premises located in government-owned buildings. The estimated fair rental value of the premises is reported as support and expense in the period in which the premises are used.

Grants

The library records income from unrestricted grants in the period designated by the grantor.

Inexhaustible Collections and Books

Because the values of the existing inexhaustible collections, including research books, are not readily determinable, the library has not capitalized them. Collections that are exhaustible are capitalized and included with equipment in the financial statements and are amortized over their estimated useful lives. Accessions and deaccessions during 19X0 and 19X1 were not significant. Books used in the circulating library have not been capitalized because their estimated useful lives are less than one year.

Summarized Financial Information for 19X0

The financial information for the year ended December 31, 19X0, presented for comparative purposes, is not intended to be complete financial statement presentation.

Note 2—Investments**Note 3—Plant Assets and Depreciation****Note 4—Long-Term Debt****Note 5—Pension Plans****Note 6—Changes in Deferred Restricted Amounts****Note 7—Functional Allocation of Expenses**

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

Note 8—Commitments and Contingencies

The library receives a substantial amount of its support from federal, state, and local governments. A significant reduction in the level of this support, if this were to occur, may have an effect on the library's programs and activities.

EXHIBIT 5—MUSEUM

EXHIBIT 5A

Sample Museum

Balance Sheet

June 30, 19X1

(With Comparative Totals for 19X0)

	<u>Operating Fund</u>	<u>Plant Fund</u>	<u>Endowment Fund</u>	<u>Total</u>	<u>June 30, 19X0 Total</u>
Assets					
Current assets					
Cash	\$ 19,800	—	—	\$ 19,800	\$ 23,700
Receivables, less reserve of \$7,700	145,500	—	—	145,500	125,800
Investments (Note 2)	210,000	—	—	210,000	—
Inventories, at lower of cost (FIFO) or market	121,100	—	—	121,100	120,600
Prepayments	26,600	—	—	26,600	12,700
Total current assets	<u>523,000</u>	<u>—</u>	<u>—</u>	<u>523,000</u>	<u>282,800</u>
Fixed assets, net of depreciation (Note 3)	—	\$1,964,000	—	1,964,000	1,866,800
Art collection (Note 11)	—	—	\$ 6,000	6,000	3,800
Cash held for investment	4,044,500	—	7,688,400	11,732,900	11,709,300
Investments (Note 2)	<u>\$4,567,500</u>	<u>\$1,964,000</u>	<u>\$7,694,400</u>	<u>\$14,225,900</u>	<u>\$13,962,700</u>
Total					

Liabilities and Fund Balances	
Current liabilities	
Accounts payable and accrued expenses	\$ 256,900
Deferred revenue and restricted gifts, current portion (Note 5)	242,100
Total current liabilities	<u>499,000</u>
Deferred revenue and restricted gifts, noncurrent portion (Note 5)	—
Fund balances	<u>409,900</u>
Endowment	—
Land, buildings, and equipment	\$7,694,400
Unrestricted	—
Designated for investment	7,694,400
Designated for plant expansion	1,964,000
Unappropriated	1,964,000
Total fund balances	<u>\$1,964,000</u>
Total	<u>\$14,225,900</u>
	<u>\$13,862,700</u>

Statements of Position

EXHIBIT 5B
Sample Museum
 Statement of Activity
 Year Ended June 30, 19X1
 (With Comparative Totals for 19X0)

	Operating Fund	Plant Fund	Endowment Fund	Total	Year Ended June 30, 19X0 Total
Support and revenue					
Admissions	\$ 131,100	—	—	\$ 131,100	\$ 123,400
Government appropriations	110,700	—	—	110,700	104,000
Gifts and grants (Notes 5 and 8)	130,000	—	—	130,000	124,700
Memberships	48,400	—	—	48,400	39,900
Investment income	828,800	—	—	828,800	841,700
Net realized investment gains (losses)	6,300	—	—	6,300	(2,600)
Revenue, auxiliary activities	483,100	—	—	483,100	417,200
Total	<u>1,738,400</u>	<u>—</u>	<u>—</u>	<u>1,738,400</u>	<u>1,646,300</u>

Expenses					
Program					
Curatorial and conservation	\$ 27,400	578,600	606,000	602,000	602,000
Exhibits	—	108,600	108,600	108,100	108,100
Education	4,800	133,400	138,200	138,200	131,600
Fellowships	—	68,200	68,200	68,200	52,800
Public information	2,700	66,400	69,100	69,100	67,700
Accession of art for collection, net of deaccessions (Note 11)	—	200,000	200,000	170,000	170,000
Supporting services					
Management and general	10,800	67,400	78,200	77,300	77,300
Fund raising	—	10,300	10,300	9,600	9,600
Cost of sales and expense of auxiliary activities	8,700	441,100	449,800	384,600	384,600
Total	<u>54,400</u>	<u>1,674,000</u>	<u>1,728,400</u>	<u>1,604,700</u>	<u>1,604,700</u>
Excess (deficiency) of support and revenue over expenses before capital additions	<u>(54,400)</u>	<u>64,400</u>	<u>10,000</u>	<u>43,600</u>	<u>43,600</u>
Capital additions					
Gifts and grants (Note 8)	\$ 76,400	—	76,400	18,200	18,200
Net investment income	4,700	—	4,700	1,800	1,800
Net realized investment gains (losses)	(8,500)	—	(8,500)	(2,000)	(2,000)
Total	<u>72,600</u>	<u>—</u>	<u>72,600</u>	<u>18,000</u>	<u>18,000</u>
Excess (deficiency) of support and revenue over expenses after capital additions	<u>(54,400)</u>	<u>64,400</u>	<u>82,600</u>	<u>61,600</u>	<u>61,600</u>
Fund balances, beginning of period	1,866,800	3,745,800	13,234,400	13,172,800	13,172,800
Add (deduct) transfers (Note 9)	151,600	(151,600)	—	—	—
Fund balances, end of period	<u>\$1,964,000</u>	<u>\$3,658,600</u>	<u>\$13,317,000</u>	<u>\$13,234,400</u>	<u>\$13,234,400</u>

Statements of Position

EXHIBIT 5C

Sample Museum

Statement of Changes in Financial Position

Year Ended June 30, 19X1

Sources of working capital	
Excess of support and revenue before capital additions	\$ 10,000
Capital additions	<u>72,600</u>
Excess of support and revenue after capital additions	82,600
Depreciation	54,400
Deferred revenue and restricted gifts received in excess of expenses incurred	242,600
Investments sold	<u>952,200</u>
	<u>1,331,800</u>
Uses of working capital	
Fixed assets purchased	151,600
Investments purchased	<u>978,000</u>
	<u>1,129,600</u>
Increase in working capital	<u>\$ 202,200</u>
Changes in working capital, increase (decrease)	
Cash	\$ (3,900)
Receivables	19,700
Investments	210,000
Inventories	500
Prepayments	13,900
Accounts payable and accrued expenses	(4,000)
Deferred revenue and restricted gifts, current portion	<u>(34,000)</u>
	<u>\$ 202,200</u>

EXHIBIT 5D

Sample Museum

Notes to Financial Statements*

June 30, 19X1

Note 1—Summary of Significant Accounting Policies

Note 2—Investments

Note 3—Fixed Assets and Depreciation

Note 4—Pension Plans

Note 5—Deferred Revenue and Restricted Gifts

Note 6—Functional Allocation of Expenses

Note 7—Commitments

Note 8—Gifts Received

Note 9—Interfund Transfers

During the year ended June 30, 19X1, the trustees authorized a transfer from the Operating Fund to the Plant Fund in the amount of \$151,600 representing fixed assets purchased with resources of the Operating Fund.

Note 10—Contributed Services

A substantial number of unpaid volunteers have made significant contributions of their time to develop the Museum's programs, principally in membership development and educational programs. The value of this contributed time is not reflected in these statements since it is not susceptible to objective measurement or valuation.

Note 11—Art Collection

In conformity with the practice followed by many museums, art objects purchased and donated are not included in the balance sheet.

The value of the objects acquired by gift for which the Museum can make a reasonable estimate is reported as gifts in the Statement of Activity (\$28,000 in the year ended June 30, 19X1).

The cost of all objects purchased together with the value of objects acquired by gift as indicated in the preceding paragraph, less the proceeds from deaccessions of objects, is reported as a separate program expense. During the year ended June 30, 19X1, purchase of art objects amounted to \$185,000 and the proceeds from deaccessions was \$13,000.

Gifts of cash or other property restricted by donors for the purchase of items for the collection are classified as deferred revenue until acquisitions are made in accordance with the terms of the gifts.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.134 EXHIBIT 6—PERFORMING ARTS ORGANIZATION

EXHIBIT 6A

Sample Performing Arts Organization
Balance Sheet
June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Assets		
Current assets		
Cash	\$216,074	\$169,466
Marketable securities (Note 2)	266,330	50,967
Accounts receivable, net of allowance for doubtful accounts	70,051	26,685
Grants receivable	—	6,100
Other	<u>39,378</u>	<u>13,441</u>
Total current assets	591,833	266,659
Noncurrent assets		
Investments and endowment funds cash (Note 2)	267,869	256,648
Property and equipment at cost, net of accumulated depreciation (Note 3)	55,061	40,226
Rent and other deposits	<u>3,839</u>	<u>9,130</u>
	<u>\$918,602</u>	<u>\$572,663</u>
Liabilities and Entity Capital		
Current liabilities		
Accounts payable and accrued expenses	\$111,150	\$166,351
Deferred revenues—subscriptions (Note 1)	297,430	193,042
Deferred revenues—grants (Note 1)	42,562	—
Current portion of long-term debt	<u>50,000</u>	<u>50,000</u>
Total current liabilities	501,142	409,393
Long-term debt (Note 4)	32,000	69,740
Contingencies (Note 6)		
Entity capital		
Plant fund	33,061	38,594
Endowment funds (Note 5)	267,869	256,648
Unrestricted funds	<u>84,530</u>	<u>(201,712)</u>
	<u>\$918,602</u>	<u>\$572,663</u>

EXHIBIT 6B

Sample Performing Arts Organization

Statement of Activity

Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Revenue and support from operations		
Admissions	\$1,557,567	\$1,287,564
Dividends and interest	21,555	2,430
Net realized gains and losses	54,700	18,300
Tuition	242,926	130,723
Concessions and other support	<u>103,582</u>	<u>68,754</u>
	<u>1,980,330</u>	<u>1,507,771</u>
Production costs	476,982	427,754
Operating expenses	797,044	685,522
Ballet school	473,658	301,722
Neighborhood productions	378,454	81,326
General and administrative expense	<u>390,487</u>	<u>469,891</u>
	<u>2,516,625</u>	<u>1,966,215</u>
Deficiency from operations	<u>(536,295)</u>	<u>(458,444)</u>
Donated services, materials, and facilities	—	8,000
Annual giving	150,379	78,469
Grants	702,368	678,322
Fund-raising costs	<u>(35,743)</u>	<u>(50,454)</u>
	<u>817,004</u>	<u>714,337</u>
Excess from current endeavors	280,709	255,893
Capital additions	<u>11,221</u>	<u>18,250</u>
Total increase in entity capital	<u>\$ 291,930</u>	<u>\$ 274,143</u>

Statements of Position

EXHIBIT 6C

Sample Performing Arts Organization**Statement of Changes in Entity Capital****Years Ended June 30, 19X1, and 19X0**

	<i>Endowment Funds</i>	<i>Plant Fund</i>	<i>Unrestricted Funds</i>	<i>Total</i>
Entity capital—June 30, 19X9	\$238,398	\$43,214	\$(462,225)	\$(180,613)
Excess from current endeavors	—	(4,620)	260,513	255,893
Capital additions	<u>18,250</u>	—	—	<u>18,250</u>
Entity capital—June 30, 19X0	256,648	38,594	(201,712)	93,530
Excess from current endeavors	—	(5,533)	286,242	280,709
Capital additions	<u>11,221</u>	—	—	<u>11,221</u>
Entity capital—June 30, 19X1	<u>\$267,869</u>	<u>\$33,061</u>	<u>\$ 84,530</u>	<u>\$ 385,460</u>

EXHIBIT 6D

Sample Performing Arts Organization
Statement of Changes in Financial Position
Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Funds provided by		
Excess from current endeavors	\$280,709	\$255,893
Add expenses not requiring outlay of working capital in current period		
Depreciation	5,533	4,620
Other deferred charges	<u>—</u>	<u>7,500</u>
Funds provided from current endeavors	286,242	268,013
Increase in long-term debt	12,260	—
Other	5,291	—
Capital additions	<u>11,221</u>	<u>18,250</u>
Total funds provided	<u>315,014</u>	<u>286,263</u>
Funds applied		
Increase in noncurrent investments and cash	11,221	—
Acquisition of property, plant, and equipment	20,368	4,362
Reduction of long-term debt	<u>50,000</u>	<u>25,280</u>
Total funds applied	<u>81,589</u>	<u>29,642</u>
Increase in working capital	<u>\$233,425</u>	<u>\$256,621</u>
Changes in the components of working capital		
Increase (decrease) in current assets		
Cash	\$ 46,608	\$220,342
Marketable securities	215,363	42,312
Accounts receivable	43,366	21,269
Grants receivable	(6,100)	—
Other	<u>25,937</u>	<u>15,413</u>
Increase in current assets	<u>325,174</u>	<u>299,336</u>
(Increase) decrease in current liabilities		
Accounts payable and accrued expenses	55,201	36,149
Deferred revenues—subscriptions	(104,388)	(78,864)
Deferred revenues—grants	<u>(42,562)</u>	<u>—</u>
(Increase) in current liabilities	<u>(91,749)</u>	<u>(42,715)</u>
Increase in working capital	<u>\$233,425</u>	<u>\$256,621</u>

EXHIBIT 6E

Sample Performing Arts Organization**Notes to Financial Statements*****June 30, 19X1, and 19X0****Note 1—Summary of Significant Accounting Policies****Note 2—Investments****Note 3—Property and Equipment****Note 4—Long-Term Debt****Note 5—Endowments**

An endowment in the amount of \$125,000 required the establishment of a ballet school. The second endowment, in the amount of \$100,000, established the organization's neighborhood production program. Income from those endowments, including capital gains, is to be used for those programs.

Note 6—Commitments and Contingencies

The organization leases its theatre and offices under a lease expiring in 19X8 at \$25,000 per year with a renewal option for ten years at the same rent. Heating, ventilating, and air-conditioning are paid separately as common area charges. The lease is not considered a capital lease under FASB Statement 13.

Grants, bequests, and endowments require the fulfillment of certain conditions as set forth in the instrument of grant. Failure to fulfill the conditions, or in the case of endowments, failure to continue to fulfill them, could result in the return of the funds to grantors. Although that is a possibility, the Board deems the contingency remote, since by accepting the gifts and their terms, it has accommodated the objectives of the organization to the provisions of the gift.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 6F
Sample Performing Arts Organization
Schedule of Functional Expenses—Supplementary Schedule
Year Ended June 30, 19X1
(With Comparative Totals for 19X0)

Item of Expense	Program Services				Support Services			Total Year Ended 19X0	
	Production Costs	Operating Expenses	Ballet School	Neighborhood Productions	Total Program Services	General and Administrative	Fund Raising		Total Year Ended 19X1
Salaries, payroll taxes, and employee benefits	\$219,370	\$464,570	\$388,113	\$306,026	\$1,378,079	\$260,755	\$15,782	\$1,654,616	\$1,312,504
Professional fees	7,864	—	2,785	—	10,649	15,624	—	26,273	21,722
Supplies	15,628	17,128	—	3,728	36,484	25,823	—	62,307	43,784
Telephone	—	—	—	—	—	10,725	1,211	11,936	10,783
Postage and shipping	—	—	—	—	—	3,816	14,439	18,255	15,622
Occupancy	—	258,622	82,760	5,478	346,860	41,540	1,527	389,927	322,147
Rental and maintenance of equipment	—	56,724	—	—	56,724	6,927	2,784	66,435	52,764
Printing and publications	—	—	—	—	—	10,381	—	10,381	10,078
Travel	—	—	—	—	—	5,824	—	5,824	4,728
Conferences, conventions, and meetings	—	—	—	—	—	2,783	—	2,783	1,568
Membership dues	—	—	—	—	—	756	—	756	2,064
Scenery	154,682	—	—	35,540	190,222	—	—	190,222	143,523
Costumes	79,438	—	—	27,682	107,120	—	—	107,120	70,762
Depreciation and amortization	—	—	—	—	—	5,533	—	5,533	4,620
Total, year ended June 30, 19X1	\$476,982	\$797,044	\$473,658	\$378,454	\$2,126,138	\$390,487	\$35,743	\$2,552,368	\$2,016,669
Total, year ended June 30, 19X0	\$427,754	\$685,522	\$301,722	\$ 81,326	\$1,496,324	\$469,891	\$50,454	\$2,016,669	\$2,016,669

EXHIBIT 7—PRIVATE FOUNDATION

EXHIBIT 7A

Sample Private Foundation

Balance Sheet

December 31, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Assets		
Cash	\$ 75,000	\$ 50,000
Accrued interest and dividends receivable	<u>175,000</u>	<u>225,000</u>
Securities, at market (cost, 19X1—\$17,800,000, 19X0—\$17,400,000) (Note 2)		
U.S. government obligations	2,000,000	1,750,000
Corporate and other obligations	5,000,000	7,000,000
Stocks	<u>12,000,000</u>	<u>10,000,000</u>
	19,000,000	18,750,000
Total assets	<u>\$19,250,000</u>	<u>\$19,025,000</u>
Liabilities and Fund Balance		
Federal excise taxes payable (Note 3)	\$ 41,000	\$ 39,000
Accrued expenses payable	9,000	11,000
Deferred taxes	10,000	5,000
Unconditional grants payable	<u>40,000</u>	<u>75,000</u>
Total liabilities	<u>100,000</u>	<u>130,000</u>
Commitments (Note 4)		
Fund balance	<u>19,150,000</u>	<u>18,895,000</u>
Total liabilities and fund balance	<u>\$19,250,000</u>	<u>\$19,025,000</u>

EXHIBIT 7B

Sample Private Foundation
Statement of Revenue, Expense, and Changes in Fund Balance
Years Ended December 31, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Revenue and support		
Dividends	\$ 525,000	\$ 500,000
Interest	500,000	585,000
Unrestricted donations	100,000	—
Total revenue and support	<u>1,125,000</u>	<u>1,085,000</u>
Expense		
Program services		
Program grants		
Health	530,000	525,000
Education	390,000	375,000
Program management	82,500	80,000
	<u>1,002,500</u>	<u>980,000</u>
Management and general expenses	72,500	70,000
Provision for federal excise taxes	40,000	38,000
	<u>112,500</u>	<u>108,000</u>
Total expense	<u>1,115,000</u>	<u>1,088,000</u>
Excess (deficiency) of revenue and support over expense before gains (losses) on securities	10,000	(3,000)
Net gains (losses) on securities	<u>245,000</u>	<u>(172,000)</u>
Excess (deficiency) for the year	255,000	(175,000)
Fund balance, beginning of year	<u>18,895,000</u>	<u>19,070,000</u>
Fund balance, end of year	<u>\$19,150,000</u>	<u>\$18,895,000</u>

Statements of Position

EXHIBIT 7C

Sample Private Foundation
Statement of Changes in Cash
Years Ended December 31, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Sources of cash		
Excess (deficiency) for the year	\$ 255,000	\$ (175,000)
Net (gains) losses on securities	(245,000)	172,000
		-
Decrease in accrued interest and dividends receivable	50,000	40,000
Proceeds on disposition of securities	<u>5,105,000</u>	<u>4,000,000</u>
	<u>5,165,000</u>	<u>4,037,000</u>
Uses of cash		
Purchase of securities	5,110,000	4,007,000
Decrease in liabilities	<u>30,000</u>	<u>40,000</u>
	<u>5,140,000</u>	<u>4,047,000</u>
Increase (decrease) in cash for year	25,000	(10,000)
Cash, beginning of year	<u>50,000</u>	<u>60,000</u>
Cash, end of year	<u>\$ 75,000</u>	<u>\$ 50,000</u>

EXHIBIT 7D

Sample Private Foundation

Notes to Financial Statements*

December 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Office Furnishings

Costs of office furnishings and equipment are consistently charged to expense because the foundation does not deem such amounts to be sufficiently material to warrant capitalization and depreciation.

Note 2—Investment in Securities

Note 3—Federal Excise Taxes

In accordance with the applicable provisions of the Tax Reform Act of 1969, the foundation is subject to an excise tax on net investment income, including realized gains, as defined in the act. Accordingly, federal excise taxes have been accrued in amounts of \$41,000 and \$39,000 as of December 31, 19X1, and 19X0, respectively.

In addition, the Tax Reform Act requires that certain minimum distributions be made in accordance with a specified formula. At December 31, 19X1, the foundation had distributed approximately \$200,000 more than the required minimum.

Note 4—Commitments

Trustees of the foundation had approved, as of December 31, 19X1, and 19X0, grants amounting to \$750,000 and \$700,000, respectively. Such grants are subject to the satisfaction by the intended recipients of prior conditions before payment. The commitments outstanding at December 31, 19X1, are scheduled for payment as follows.

<u>Year</u>	<u>Amount</u>
19X2	\$600,000
19X3	100,000
19X4	<u>50,000</u>
	<u>\$750,000</u>

Note 5—Pension Plans

Note 6—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 8—PUBLIC BROADCASTING STATION

EXHIBIT 8A
Sample Public Broadcasting Station
Balance Sheet
December 31, 19X1, and 19X0

	<u>19X1</u>			<u>19X0</u>
	<u>Unrestricted</u>	<u>Restricted</u>	<u>Total</u>	<u>Total</u>
Assets				
Current assets				
Cash	\$ 78,000	\$ 24,000	\$ 102,000	\$ 71,000
Accounts receivable, principally grants, net of allowance for doubtful accounts of \$4,000 in 19X1, and \$9,000 in 19X0 (Note 2)	192,000	80,000	272,000	245,000
Costs incurred for programs not yet telecast (Note 1)	117,000	74,000	191,000	176,000
Other assets	<u>105,000</u>	<u>—</u>	<u>105,000</u>	<u>89,000</u>
Total current assets	<u>492,000</u>	<u>178,000</u>	<u>670,000</u>	<u>581,000</u>
Property and equipment (Notes 1 and 3)				
Leasehold improvements, net of accumulated amortization of \$154,000 in 19X1, and \$94,000 in 19X0	359,000	—	359,000	374,000
Television and other equipment, net of accumulated depreciation of \$672,000 in 19X1, and \$407,000 in 19X0	<u>1,568,000</u>	<u>—</u>	<u>1,568,000</u>	<u>1,676,000</u>
	<u>1,927,000</u>	<u>—</u>	<u>1,927,000</u>	<u>2,050,000</u>
Total assets	<u>\$2,419,000</u>	<u>\$178,000</u>	<u>\$2,597,000</u>	<u>\$2,631,000</u>
Liabilities and Fund Balance				
Current liabilities				
Accounts payable and accrued expenses	\$ 113,000	—	\$ 113,000	\$ 186,000
Deferred revenue for programs not yet telecast (Notes 1 and 7)	—	\$178,000	178,000	270,000
Current portion of long-term debt (Note 4)	<u>50,000</u>	<u>—</u>	<u>50,000</u>	<u>—</u>
Total current liabilities	163,000	178,000	341,000	456,000
Long-term debt (Note 4)	<u>250,000</u>	<u>—</u>	<u>250,000</u>	<u>300,000</u>
Total liabilities	413,000	178,000	591,000	756,000
Fund balance	<u>2,006,000</u>	<u>—</u>	<u>2,006,000</u>	<u>1,875,000</u>
Total liabilities and fund balance	<u>\$2,419,000</u>	<u>\$178,000</u>	<u>\$2,597,000</u>	<u>\$2,631,000</u>

EXHIBIT 8B

Sample Public Broadcasting Station
Statement of Revenue, Expenses, and
Changes in Fund Balance
Years Ended December 31, 19X1, and 19X0

	<i>19X1</i>			<i>19X0</i>
	<u><i>Unrestricted</i></u>	<u><i>Restricted</i></u>	<u><i>Total</i></u>	<u><i>Total</i></u>
Revenue (Note 2)				
Contributions	\$ 946,000	—	\$ 946,000	\$ 790,000
Community service grants	—	\$327,000	327,000	287,000
Other grants	—	189,000	189,000	155,000
Telecasting and production	286,000	—	286,000	302,000
Facilities rental	36,000	—	36,000	31,000
Total revenue	<u>1,268,000</u>	<u>516,000</u>	<u>1,784,000</u>	<u>1,565,000</u>
Expenses				
Program services				
Programming production, including designated projects (Note 1)	274,000	335,000	609,000	563,000
Broadcasting and technical	385,000	—	385,000	279,000
Public information	162,000	—	162,000	134,000
Total program expenses	<u>821,000</u>	<u>335,000</u>	<u>1,156,000</u>	<u>976,000</u>
Supporting services				
General administration	372,000	136,000	508,000	421,000
Fund raising	146,000	45,000	191,000	154,000
Total supporting expenses	<u>518,000</u>	<u>181,000</u>	<u>699,000</u>	<u>575,000</u>
Total expenses	<u>1,339,000</u>	<u>516,000</u>	<u>1,855,000</u>	<u>1,551,000</u>
Excess (deficiency) of revenue over expenses before special grants	(71,000)	<u>—</u>	(71,000)	14,000
Special grants	<u>202,000</u>		<u>202,000</u>	<u>107,000</u>
Excess for the year	131,000		131,000	121,000
Fund balance, beginning of year	<u>1,875,000</u>		<u>1,875,000</u>	<u>1,754,000</u>
Fund balance, end of year	<u>\$2,006,000</u>		<u>\$2,006,000</u>	<u>\$1,875,000</u>

EXHIBIT 8C

Sample Public Broadcasting Station
Statement of Changes in Financial Position
Years Ended December 31, 19X1, and 19X0

	19X1			19X0
	<i>Unrestricted</i>	<i>Restricted</i>	<i>Total</i>	<i>Total</i>
Financial resources were provided by				
Excess (deficiency) of revenue over expenses before special grants	\$ (71,000)	—	\$ (71,000)	\$ 14,000
Special grants	<u>202,000</u>	<u>—</u>	<u>202,000</u>	<u>107,000</u>
Excess for the year	131,000	—	131,000	121,000
Add items not requiring working capital—amortization and depreciation	<u>325,000</u>	<u>—</u>	<u>325,000</u>	<u>281,000</u>
Working capital provided by operations	456,000	—	456,000	402,000
Increase in long-term debt	<u>—</u>	<u>—</u>	<u>—</u>	<u>300,000</u>
Total resources provided	<u>456,000</u>	<u>—</u>	<u>456,000</u>	<u>702,000</u>
Financial resources were used for				
Leasehold improvements	45,000	—	45,000	30,000
Purchases of property and equipment	157,000	—	157,000	457,000
Reduction of long-term debt	<u>50,000</u>	<u>—</u>	<u>50,000</u>	<u>—</u>
Total resources used	<u>252,000</u>	<u>—</u>	<u>252,000</u>	<u>487,000</u>
Increase in working capital	<u>\$204,000</u>	<u>—</u>	<u>\$204,000</u>	<u>\$215,000</u>
Analysis of changes in working capital				
Increase (decrease) in current assets				
Cash	\$ 57,000	\$(26,000)	\$ 31,000	\$ 25,000
Accounts receivable	62,000	(35,000)	27,000	49,000
Costs incurred for programs not yet telecast	46,000	(31,000)	15,000	45,000
Other assets	<u>16,000</u>	<u>—</u>	<u>16,000</u>	<u>21,000</u>
	<u>181,000</u>	<u>(92,000)</u>	<u>89,000</u>	<u>140,000</u>
Decrease (increase) in current liabilities				
Accounts payable and accrued expenses	73,000	—	73,000	32,000
Deferred revenue for programs not yet telecast	—	92,000	92,000	43,000
Current portion of long-term debt	<u>(50,000)</u>	<u>—</u>	<u>(50,000)</u>	<u>—</u>
	<u>23,000</u>	<u>92,000</u>	<u>115,000</u>	<u>75,000</u>
	<u>\$204,000</u>	<u>—</u>	<u>\$204,000</u>	<u>\$215,000</u>

EXHIBIT 8D

Sample Public Broadcasting Station
Notes to Financial Statements*
December 31, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type or organization.)

Programs Not Yet Telecast

Costs incurred for programs not yet telecast relate to programs that will be aired principally in the next fiscal year. Grants and contributions relating to programs not yet telecast are included as deferred revenue. As the programs are telecast, the costs incurred will be included in operating expenses and the deferred revenue will be included in revenue.

Note 2—Grants

Note 3—Property and Equipment

Note 4—Long-Term Debt

Note 5—Lease Commitments

Note 6—Retirement Plans

Note 7—Changes in Restricted Deferred Revenue

Note 8—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 9—RELIGIOUS ORGANIZATION

EXHIBIT 9A
Sample Religious Organization
Balance Sheet
December 31, 19X1

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Assets

Cash
 Accounts receivable, less allowance for
 doubtful receivables of \$12,000
 Pledges receivable, less allowance for
 doubtful pledges of \$25,000
 Investments (Note 2)
 Loans receivable, less allowance for
 doubtful loans of \$350,000
 Advances to plant funds
 Land, buildings, and equipment at cost,
 less accumulated depreciation of
 \$23,500,000 (Note 3)
 Other assets

Total assets

	Expendable Funds			Nonexpendable Funds			Total All Funds
	Operating	Deposit and Loan	Total	Plant Fund	Endowment	Annuity and Life Income	
	\$1,750,000	\$ 10,000	\$ 1,760,000	\$ 408,000	\$ 20,000	\$ 2,000	\$ 2,190,000
	520,000	—	520,000	—	—	—	520,000
	500,000	—	500,000	80,000	—	—	580,000
	3,800,000	300,000	4,100,000	260,000	1,300,000	178,000	5,838,000
	—	2,600,000	2,600,000	—	—	—	2,600,000
	—	3,500,000	3,500,000	—	—	—	— *
	—	—	—	44,800,000	—	—	44,800,000
	<u>150,000</u>	<u>—</u>	<u>150,000</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>150,000</u>
	<u>\$6,720,000</u>	<u>\$6,410,000</u>	<u>\$13,130,000</u>	<u>\$45,548,000</u>	<u>\$1,320,000</u>	<u>\$180,000</u>	<u>\$56,678,000</u>

Liabilities and Fund Balances									
Accounts payable and accrued expenses									
Deferred amounts (Note 6)									
Unrestricted	160,000								160,000
Restricted	870,000			328,000				60,000	1,258,000
Advances from expendable funds				3,500,000					— *
Deposits payable									7,310,000
Long-term debt (Note 4)									2,800,000
Total liabilities	1,630,000		7,310,000	6,648,000				180,000	12,268,000
Fund balances (deficit)									
Unrestricted									
Designated for long-term investment	3,800,000								3,800,000
Undesignated	1,290,000	(900,000)							390,000
Restricted	5,090,000	(900,000)							4,190,000
Net investment in plant							\$1,320,000		1,320,000
Total fund balances (deficit)	5,090,000	(900,000)		38,900,000					38,900,000
Total liabilities and fund balances	\$6,720,000	\$6,410,000	\$13,130,000	\$45,548,000			\$1,320,000	\$180,000	\$56,678,000

* Interfund borrowings eliminated in combination

Statements of Position

EXHIBIT 9B
Sample Religious Organization
Statement of Support and Revenue, Expenses,
Capital Additions, and Changes in Fund Balances
Year Ended December 31, 19X1

	Expendable Funds			Plant Fund	Nonexpendable Endowment Funds	Total All Funds
	Operating	Restricted	Deposit and Loan			
	Unrestricted	Restricted	Total			
Support and revenue						
Contributions and bequests	\$ 6,800,000	\$180,000	\$ 6,980,000	—	—	\$ 6,980,000
Fees for services	4,000,000	—	4,000,000	—	—	4,000,000
Endowment and other investment income	200,000	40,000	240,000	—	—	240,000
Net gain on investment transactions	250,000	—	250,000	—	—	250,000
Contributed services	950,000	—	950,000	—	—	950,000
Auxiliary activities	205,000	—	\$535,000	—	—	740,000
Total support and revenue	12,405,000	220,000	13,160,000	—	—	13,160,000
Expenses						
Program services						
Pastoral	3,300,000	45,000	3,345,000	\$ 300,000	—	3,645,000
Education	4,000,000	80,000	4,080,000	460,000	—	4,540,000
Health care	2,800,000	25,000	2,825,000	250,000	—	3,075,000
Social services	900,000	50,000	950,000	85,000	—	1,035,000
Cemeteries	220,000	20,000	240,000	20,000	—	260,000
Religious personnel development	600,000	—	600,000	55,000	—	655,000
Auxiliary activities	160,000	—	845,000	5,000	—	850,000
Total program services	11,980,000	220,000	12,885,000	1,175,000	—	14,060,000

**Accounting Principles and Reporting Practices for
Certain Nonprofit Organizations**

18,667

Supporting services									
General administration						180,000			195,000
Fund raising						120,000		15,000	130,000
Total supporting services						<u>300,000</u>		<u>10,000</u>	<u>325,000</u>
Total expenses						12,280,000	685,000	<u>1,200,000</u>	<u>14,385,000</u>
Excess (deficiency) of support and revenue over expenses before capital additions						<u>125,000</u>	<u>(150,000)</u>	<u>(1,200,000)</u>	<u>(1,225,000)</u>
Capital additions									
Contributions and bequests									
Investment income								310,000	510,000
Net gain on investment transactions								15,000	15,000
Total capital additions								<u>80,000</u>	<u>80,000</u>
Excess (deficiency) of support and revenue over expenses after capital additions								<u>325,000</u>	<u>605,000</u>
Fund balances (deficit) at beginning of year						125,000	(150,000)	(875,000)	(620,000)
Transfers to plant funds for plant acquisitions and principal debt service payments financed from operating funds						5,315,000	(750,000)	39,425,000	45,030,000
Fund balances (deficit) at end of year						<u>(350,000)</u>	<u>(900,000)</u>	<u>350,000</u>	<u>\$44,410,000</u>
						<u>\$ 5,090,000</u>	<u>\$4,190,000</u>	<u>\$38,900,000</u>	<u>\$1,320,000</u>

EXHIBIT 9C
Sample Religious Organization
Statement of Changes in Financial Position
Year Ended December 31, 19X1

	Expendable Funds			Nonexpendable Funds			Total All Funds
	Operating	Deposit and Loan	Total	Plant Fund	Endowment	Annuity and Life Income	
Resources provided							
Excess (deficiency) of support and revenue over expenses before capital additions	\$ 125,000	\$(150,000)	\$ (25,000)	\$(1,200,000)	—	—	\$(1,225,000)
Capital additions	—	—	—	310,000	\$200,000	—	510,000
Contributions and bequests	—	—	—	15,000	—	—	15,000
Investment income	—	—	—	—	80,000	—	80,000
Net gain on investment transactions							
Excess (deficiency) of support and revenue over expenses after capital additions	125,000	(150,000)	(25,000)	(875,000)	280,000	—	(620,000)
Items that do not use (provide) resources							
Provision for depreciation	—	—	—	1,200,000	—	—	1,200,000
Net gain on investment transactions	(250,000)	(15,000)	(265,000)	—	(80,000)	\$(12,000)	(357,000)
Issuance of long-term debt	—	—	—	400,000	—	—	400,000
Increase in deferred amounts	650,000	—	650,000	3,000	—	2,000	655,000
Proceeds from sale of investments	1,800,000	210,000	2,010,000	332,000	590,000	49,000	2,981,000
Total resources provided	2,325,000	45,000	2,370,000	1,060,000	790,000	39,000	4,259,000

Resources provided
 Excess (deficiency) of support and revenue over expenses before capital additions
 Capital additions
 Contributions and bequests
 Investment income
 Net gain on investment transactions
 Excess (deficiency) of support and revenue over expenses after capital additions
 Items that do not use (provide) resources
 Provision for depreciation
 Net gain on investment transactions
 Issuance of long-term debt
 Increase in deferred amounts
 Proceeds from sale of investments
 Total resources provided

Resources used									
Purchases of building and equipment	—	—	755,000	—	—	—	—	—	755,000
Reduction of long-term debt	—	—	320,000	—	—	—	—	—	320,000
Purchases of investments	1,830,000	70,000	—	784,000	36,000	—	—	—	2,720,000
Increase in accounts and pledges receivable	400,000	—	5,000	—	—	—	—	—	405,000
Increase in loans receivable	—	45,000	—	—	—	—	—	—	45,000
Decrease in accounts payable and accrued expenses	70,000	—	10,000	—	—	—	—	—	82,000
Decrease in deposits payable	—	10,000	—	—	—	—	—	—	10,000
Total resources used	<u>2,300,000</u>	<u>125,000</u>	<u>1,090,000</u>	<u>784,000</u>	<u>38,000</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>4,337,000</u>
Transfers to plant funds for plant acquisitions and principal debt service payments financed from operating funds	(350,000)	—	350,000	—	—	—	—	—	—
Increase (decrease) in cash	<u>\$ (325,000)</u>	<u>\$ (80,000)</u>	<u>\$ 320,000</u>	<u>\$ 6,000</u>	<u>\$ 1,000</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ (78,000)</u>	<u>\$ —</u>

EXHIBIT 9D

Sample Religious Organization**Notes to Financial Statements*****December 31, 19X1****Note 1—Summary of Significant Accounting Policies**

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Basis of Presentation

The accompanying financial statements include the assets, liabilities, fund balances, and financial activities of all institutions and organizations providing services at the level of administration above the individual congregation. All significant balances and transactions among the organizations included in the financial statements have been eliminated.

Other Matters

Support arising from contributed services of certain religious personnel has been recognized in the accompanying financial statements. The computation of the value of the contribution of those services represents the difference between the stipends and other amounts paid to or on behalf of the religious personnel and the comparable compensation that would be paid to lay persons if lay persons were to occupy those positions. No computation is made for positions that can be held only by religious personnel.

Note 2—Investments**Note 3—Plant Assets and Depreciation****Note 4—Long-Term Debt****Note 5—Pension Plans****Note 6—Changes in Deferred Restricted Amounts****Note 7—Functional Allocation of Expenses****Note 8—Commitment**

The organization has a lease for certain office facilities that expires December 31, 19X9. The lease contains operating expense and real estate tax escalation clauses. The minimum rental commitment on the lease as of December 31, 19X1, aggregates approximately \$210,000 with annual payments ranging from \$25,000 to \$35,000. Rent expense for the year ended December 31, 19X1, amounted to \$28,000.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 10—RESEARCH AND SCIENTIFIC ORGANIZATION

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EXHIBIT 10A
Sample Research and Scientific Organization
Balance Sheet
June 30, 19X1, and 19X0

Assets	<u>19X1</u>	<u>19X0</u>	Liabilities and Fund Balance	<u>19X1</u>	<u>19X0</u>
Current assets			Current liabilities		
Cash	\$ 125,000	\$ 115,000	Accounts payable and accrued expenses	\$ 418,000	\$ 388,000
Certificates of deposit	200,000	210,000	Restricted grant advances (Note 2)	261,000	210,000
Accounts receivable	372,000	346,000	Obligations under capital leases (Note 4)	88,000	82,000
Unbilled contract revenues and reimbursable grant expenses	488,000	390,000	Total current liabilities	<u>767,000</u>	<u>680,000</u>
Prepaid expenses and other current assets	40,000	38,000	Noncurrent capital lease obligations (Note 4)	<u>309,000</u>	<u>397,000</u>
Total current assets	<u>1,225,000</u>	<u>1,099,000</u>		<u>1,076,000</u>	<u>1,077,000</u>
Property, plant, and equipment (Notes 1 and 4)					
Land and building	220,000	220,000			
Furniture and equipment	167,000	156,000			
Leased property under capital leases	479,000	479,000			
	<u>866,000</u>	<u>855,000</u>			
Less—accumulated depreciation and amortization	<u>259,000</u>	<u>185,000</u>	Fund balance	458,000	419,000
	<u>607,000</u>	<u>670,000</u>	Unrestricted	298,000	273,000
	<u>\$1,832,000</u>	<u>\$1,769,000</u>	Net equity in fixed assets	<u>756,000</u>	<u>692,000</u>
			Total fund balance	<u>\$1,832,000</u>	<u>\$1,769,000</u>

EXHIBIT 10B

Sample Research and Scientific Organization
Statement of Revenues, Expenses, and
Changes in Fund Balance
Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Revenues (Notes 1, 2, and 3)		
Contract revenues—U S government	\$ 5,958,000	\$5,578,000
Restricted grants—foundations and individuals	4,752,000	4,172,000
Other, including interest	<u>43,000</u>	<u>41,000</u>
	<u>10,753,000</u>	<u>9,791,000</u>
Expenses		
Research and development		
Environmental	5,263,000	4,997,000
Health	2,992,000	2,766,000
National defense	1,166,000	938,000
Management and general	1,103,000	985,000
Contract and grant procurement	<u>165,000</u>	<u>151,000</u>
	<u>10,689,000</u>	<u>9,837,000</u>
Excess (deficiency) of revenues over expenses	64,000	(46,000)
Fund balance, beginning of year	<u>692,000</u>	<u>738,000</u>
Fund balance, end of year	<u>\$ 756,000</u>	<u>\$ 692,000</u>

EXHIBIT 10C

Sample Research and Scientific Organization

Statement of Changes in Financial Position

Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Financial resources were provided by		
Excess (deficiency) of revenues over expenses	\$ 64,000	\$ (46,000)
Add—expenses not requiring current outlay of working capital— depreciation and amortization	<u>74,000</u>	<u>26,000</u>
Working capital provided by (used in) operations	138,000	(20,000)
Financing of fixed asset additions through capital leases	<u>—</u>	<u>397,000</u>
Total resources provided	<u>138,000</u>	<u>377,000</u>
Financial resources were used for		
Acquisition of property, plant, and equipment	11,000	481,000
Reduction of noncurrent capital lease obligations	<u>88,000</u>	<u>—</u>
Total resources used	<u>99,000</u>	<u>481,000</u>
Increase (decrease) in working capital	<u>\$ 39,000</u>	<u>\$(104,000)</u>
Changes in working capital were represented by		
Increase (decrease) in current assets—		
Cash	\$ 10,000	\$ (14,000)
Certificates of deposit	(10,000)	(40,000)
Accounts receivable	26,000	10,000
Unbilled contract revenues and reimbursable grant expenses	98,000	42,000
Other	<u>2,000</u>	<u>(1,000)</u>
	<u>126,000</u>	<u>(3,000)</u>
(Increase) decrease in current liabilities—		
Accounts payable and accrued expenses	(30,000)	(23,000)
Restricted grant advances	(51,000)	4,000
Obligations under capital leases	<u>(6,000)</u>	<u>(82,000)</u>
	<u>(87,000)</u>	<u>(101,000)</u>
Increase (decrease) in working capital	<u>\$ 39,000</u>	<u>\$(104,000)</u>

EXHIBIT 10D

Sample Research and Scientific Organization**Notes to Financial Statements****June 30, 19X1, and 19X0***Note 1—Summary of Significant Accounting Policies**

(In addition to the policy disclosures illustrated in Note 1 of exhibit 1, the following are typical of additional disclosures to be considered for this type of organization.)

Revenue Recognition

Substantially all of the organization's revenue is derived from restricted grants and cost-plus-fixed-fee contracts. Revenue is recognized based on the proportion of project expenses incurred to total anticipated project expenses (percentage-of-completion method). Losses on contracts are recognized when identified.

Note 2—Restricted Grants**Note 3—Government Contracts**

Certain contract costs billed to the U.S. government are subject to audit by the Defense Contract Audit Agency. The agency has audited costs billed before July 1, 19X0.

Note 4—Lease Commitments

The organization uses data processing equipment under capital leases expiring in 19X7 which provide for the transfer of ownership of the equipment at the end of the lease term. The related future minimum lease payments as of June 30, 19X1, are as follows:

19X2	\$ 94,000
19X3	94,000
19X4	94,000
19X5	94,000
19X6	94,000
19X7	<u>10,000</u>
	480,000
Less—amount representing interest	<u>(83,000)</u>
Present value of minimum lease payments	<u>\$397,000</u>

Note 5—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

EXHIBIT 11—TRADE ASSOCIATION

EXHIBIT 11A
Sample Trade Association
Balance Sheet
June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Assets		
Current assets		
Cash	\$ 15,000	\$ 24,000
Marketable securities, at market (Note 2)	433,000	330,000
Accounts receivable, net of allowance for doubtful accounts of \$6,000 in 19X1 and \$8,000 in 19X0	51,000	67,000
Publications inventory, at lower of cost (FIFO) or market	<u>122,000</u>	<u>80,000</u>
Total current assets	621,000	501,000
Long-term investments, at market (Note 2)	240,000	250,000
Fixed assets, at cost, net of accumulated depreciation of \$45,000 in 19X1 and \$26,000 in 19X0 (Note 1)	66,000	60,000
Other assets	<u>56,000</u>	<u>46,000</u>
Total assets	<u>\$983,000</u>	<u>\$857,000</u>
Liabilities and Fund Balance		
Current liabilities		
Accounts payable and accrued expenses	\$ 96,000	\$ 41,000
Deferred membership dues (Note 1)	<u>262,000</u>	<u>245,000</u>
Total current liabilities	358,000	286,000
Fund balance	<u>625,000</u>	<u>571,000</u>
Total liabilities and fund balance	<u>\$983,000</u>	<u>\$857,000</u>

Statements of Position

EXHIBIT 11B

Sample Trade Association

Statement of Revenue, Expenses, and Changes in Fund Balance

Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Revenue		
Membership dues (Note 1)	\$ 369,000	\$ 279,000
Conferences and meetings	642,000	601,000
Publication sales and advertising	285,000	275,000
Special assessments	101,000	95,000
Investment income including net gains on investments	<u>21,000</u>	<u>23,000</u>
Total revenue	<u>1,418,000</u>	<u>1,273,000</u>
Expenses (Note 5)		
Member services	113,000	109,000
Conferences and meetings	335,000	334,000
Technical services	437,000	472,000
Communications, including publication of magazine	<u>122,000</u>	<u>72,000</u>
Total program expenses	1,007,000	987,000
General administration	308,000	219,000
Membership development	<u>49,000</u>	<u>38,000</u>
Total expenses	<u>1,364,000</u>	<u>1,244,000</u>
Excess of revenue over expenses	54,000	29,000
Fund balance, beginning of year	<u>571,000</u>	<u>542,000</u>
Fund balance, end of year	<u>\$ 625,000</u>	<u>\$ 571,000</u>

EXHIBIT 11C

Sample Trade Association
Statement of Changes in Financial Position
Years Ended June 30, 19X1, and 19X0

	<u>19X1</u>	<u>19X0</u>
Funds were provided by		
Excess of revenue over expenses	\$ 54,000	\$29,000
Add item not requiring funds—depreciation	<u>19,000</u>	<u>12,000</u>
Funds provided by operations	73,000	41,000
Sale of long-term investments	<u>10,000</u>	<u>—</u>
Total funds provided	<u>83,000</u>	<u>41,000</u>
Funds were used for		
Purchase of fixed assets	(25,000)	—
Increase in other assets	<u>(10,000)</u>	<u>(25,000)</u>
Total funds used	<u>(35,000)</u>	<u>(25,000)</u>
Increase in working capital	<u>\$ 48,000</u>	<u>\$16,000</u>
Analysis of changes in working capital		
Increase (decrease) in current assets		
Cash	\$ (9,000)	\$17,000
Marketable securities	103,000	21,000
Accounts receivable	(16,000)	(8,000)
Publications inventory	<u>42,000</u>	<u>16,000</u>
	<u>120,000</u>	<u>46,000</u>
Decrease (increase) in current liabilities		
Accounts payable and accrued expenses	(55,000)	(17,000)
Deferred membership dues	<u>(17,000)</u>	<u>(13,000)</u>
	<u>(72,000)</u>	<u>(30,000)</u>
	<u>\$ 48,000</u>	<u>\$16,000</u>

EXHIBIT 11D

Sample Trade Association
Notes to Financial Statements*
June 30, 19X1, and 19X0

Note 1—Summary of Significant Accounting Policies

Note 2—Investments

Note 3—Pension Plan

Note 4—Lease Agreements/Commitments

Note 5—Functional Allocation of Expenses

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

Statements of Position

EXHIBIT 12—UNION

EXHIBIT 12A

Sample Union
Balance Sheet

December 31, 19X1
(With Comparative Totals for 19X0)

	<u>General Fund (Undesignated)</u>	<u>Strike Insurance Fund (Designated)</u>	<u>December 31, 19X1 Total</u>	<u>December 31, 19X0 Total</u>
Assets				
Current assets				
Cash (including savings accounts of \$2,100,000 and \$1,050,000) (Note 3)	\$ 650,800	\$ 1,710,000	\$ 2,360,800	\$ 1,238,100
Investments at market	491,800	9,054,200	9,546,000	9,640,400
Per capita dues receivable	51,800	133,200	185,000	189,500
Accrued interest receivable	1,800	210,700	212,500	214,600
Loans to affiliated organizations (Note 4)	21,400	—	21,400	27,300
Accounts receivable (less allowance for doubtful accounts of \$2,300 and \$2,500)	67,900	—	67,900	68,900
Prepaid expenses	<u>74,900</u>	<u>—</u>	<u>74,900</u>	<u>71,500</u>
Total current assets	<u>\$ 1,360,400</u>	<u>\$ 11,108,100</u>	<u>\$ 12,468,500</u>	<u>\$ 11,450,300</u>

Property, furniture, and equipment at cost (Note 1)
 Land 678,400
 Buildings (net of accumulated depreciation
 of \$743,500 and \$675,600) 1,973,400
 Furniture and equipment (net of accumulated
 depreciation of \$314,800 and \$278,200) 50,800
 Total property, furniture, and equipment 2,702,600
 Total assets \$4,063,000

Liabilities and Fund Balances

Current liabilities
 Accounts payable \$ 337,600
 Notes payable 13,100
 Affiliation dues payable 48,800
 Accrued salaries 31,500
 Payroll taxes and employee deductions payable 89,300
 Total current liabilities 520,300
 Fund balances 3,542,700
 Total liabilities and fund balances \$4,063,000

678,400
 1,973,400
 50,800
 2,702,600
 \$15,171,100

\$ 423,100
 19,600
 49,600
 33,000
 90,400
 615,700
 13,115,900
 \$13,731,600

678,400
 1,973,400
 50,800
 2,702,600
 \$4,063,000

\$ 337,600
 13,100
 48,800
 31,500
 89,300
 520,300
 3,542,700
 \$4,063,000

Statements of Position

EXHIBIT 12B
Sample Union
Statement of Revenue, Expense, and Changes in Fund Balances
Year Ended December 31, 19X1
(With Comparative Totals for 19X0)

	<u>General Fund</u> <i>(Undesignated)</i>	<u>Strike Insurance Fund</u> <i>(Designated)</i>	<u>December 31, 19X1</u> <i>Total</i>	<u>December 31, 19X0</u> <i>Total</i>
Revenue				
Per capita dues (Note 2)	\$9,385,500	\$ 3,532,300	\$12,917,800	\$13,219,800
Initiation fees	24,100	—	24,100	22,800
Sales of organizational supplies	26,700	—	26,700	17,900
Rental income	216,300	—	216,300	216,100
Administrative fees—apprentice training	11,800	—	11,800	12,100
Interest income	<u>28,100</u>	<u>609,000</u>	<u>637,100</u>	<u>644,100</u>
Total revenue	<u>9,692,500</u>	<u>4,141,300</u>	<u>13,833,800</u>	<u>14,132,800</u>

Expense (Note 6)					
Program services	877,900	2,630,500	3,508,400	3,345,600	
Strike assistance to local unions	154,600	—	154,600	132,800	
Constitutional convention					
Field office services					
Organization	2,054,000	—	2,054,000	2,106,500	
Negotiation	2,156,700	—	2,156,700	2,212,000	
Grievance	924,300	—	924,300	947,900	
Total program services	6,167,500	2,630,500	8,798,000	8,744,800	
Administrative and general	3,537,700	57,600	3,595,300	1,425,200	
Net (gains) losses on investments	(94,400)	—	(94,400)	2,062,800	
Total expense	9,610,800	2,688,100	12,298,900	12,232,800	
Excess of revenue over expense	81,700	1,453,200	1,534,900	1,900,000	
Fund balances, beginning of year	3,461,000	9,654,900	13,115,900	11,215,900	
Fund balances, end of year	\$3,542,700	\$11,108,100	\$14,650,800	\$13,115,900	

Statements of Position

EXHIBIT 12C
Sample Union
Statement of Changes in Financial Position
Year Ended December 31, 19X1
(With Comparative Totals for 19X0)

	<u>General Fund (Undesignated)</u>	<u>Strike Insurance Fund (Designated)</u>	<u>December 31, 19X1 Total</u>	<u>December 31, 19X0 Total</u>
Sources of working capital				
Excess of revenue over expense	\$ 81,700	\$ 1,453,200	\$1,534,900	\$1,900,000
Add charges not affecting working capital				
Depreciation	<u>104,500</u>	<u>—</u>	<u>104,500</u>	<u>100,300</u>
Working capital provided	<u>186,200</u>	<u>1,453,200</u>	<u>1,639,400</u>	<u>2,000,300</u>
Use of working capital				
Purchase of property, furniture, and equipment	<u>525,800</u>	<u>—</u>	<u>525,800</u>	<u>352,000</u>
Increase (decrease) in working capital	<u>\$(339,600)</u>	<u>\$1,453,200</u>	<u>\$1,113,600</u>	<u>\$1,648,300</u>

<p>Changes in working capital</p> <p>Increase (decrease) in current assets</p> <p>Cash</p> <p>Investments</p> <p>Per capita dues receivable</p> <p>Accrued interest receivable</p> <p>Loans to affiliated organizations</p> <p>Accounts receivable</p> <p>Prepaid expenses</p>	<p>\$ (413,900)</p> <p>(15,900)</p> <p>(1,300)</p> <p>(400)</p> <p>(5,900)</p> <p>(1,000)</p> <p>3,400</p> <hr/> <p>(435,000)</p>	<p>\$ 1,536,600</p> <p>(78,500)</p> <p>(3,200)</p> <p>(1,700)</p> <p>—</p> <p>—</p> <p>—</p> <hr/> <p>1,453,200</p>	<p>\$ 1,122,700</p> <p>(94,400)</p> <p>(4,500)</p> <p>(2,100)</p> <p>(5,900)</p> <p>(1,000)</p> <p>3,400</p> <hr/> <p>1,018,200</p>	<p>\$ 186,300</p> <p>1,425,200</p> <p>(2,300)</p> <p>(1,200)</p> <p>(2,600)</p> <p>(100)</p> <p>2,900</p> <hr/> <p>1,608,200</p>
<p>Increase (decrease) in current liabilities</p> <p>Accounts payable</p> <p>Notes payable</p> <p>Affiliation dues payable</p> <p>Accrued salaries</p> <p>Payroll taxes and employee deductions payable</p> <p>Increase (decrease) in working capital</p>	<p>(85,500)</p> <p>(6,500)</p> <p>(800)</p> <p>(1,500)</p> <p>(1,100)</p> <p>(95,400)</p> <p>(339,600)</p> <hr/> <p>\$ (339,600)</p>	<p>—</p> <p>—</p> <p>—</p> <p>—</p> <p>—</p> <p>—</p> <hr/> <p>1,453,200</p>	<p>(85,500)</p> <p>(6,500)</p> <p>(800)</p> <p>(1,500)</p> <p>(1,100)</p> <p>(95,400)</p> <p>(1,113,600)</p> <hr/> <p>\$ 1,113,600</p>	<p>(32,200)</p> <p>(6,500)</p> <p>(200)</p> <p>(800)</p> <p>(400)</p> <p>(40,100)</p> <p>(1,648,300)</p> <hr/> <p>\$ 1,648,300</p>

EXHIBIT 12D

Sample Union**Notes to Financial Statements****December 31, 19X1, and 19X0***Note 1—Summary of Significant Accounting Policies****Note 2—Strike Insurance Fund**

In accordance with the provisions of the Union Constitution, 27 percent of the per capita dues paid to the Union are designated for the Strike Insurance Fund. The fund may be distributed for strike relief at the discretion of the Union Executive Board. No charges may be made against the fund for administrative expenses.

Note 3—Pledged Assets and Contingent Liabilities

The Union is contingently liable as guarantor of a loan of \$15,000 to an affiliated local. In connection with the guarantee, a savings account, having a balance of \$20,000, is pledged as collateral for the loan.

Note 4—Loans to Affiliated Organizations

The loans to affiliated organizations represent short-term loans to local unions at current interest rates. All such loans are expected to be collected within one year.

Note 5—Pension Plan**Note 6—Functional Allocation of Expenses**

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

.141 EXHIBIT 13—ZOOLOGICAL AND BOTANICAL SOCIETY

EXHIBIT 13A

Sample Zoological and Botanical Society

Balance Sheet

December 31, 19X1

	<i>Operating Funds</i>	<i>Plant Fund</i>	<i>Endowment Funds</i>	<i>Total All Funds</i>
Assets				
Cash	\$ 257,000	\$ 20,000	\$ 50,000	\$ 327,000
Accounts receivable, less allowance for doubtful receivables of \$18,000	125,000	—	—	125,000
Pledges receivable, less allowance for doubtful pledges of \$95,000	520,000	120,000	—	640,000
Inventories, at lower of cost (FIFO) or market	330,000	—	—	330,000
Investments (Note 2)	7,800,000	3,000,000	2,800,000	13,600,000
Land, buildings, and equipment, at cost or fair value at date of gift, less accumu- lated depreciation of \$10,500,000 (Note 3)	—	23,000,000	—	23,000,000
Other assets	180,000	—	—	180,000
Collections (Note 9)	—	—	—	—
Total assets	<u>\$9,212,000</u>	<u>\$26,140,000</u>	<u>\$2,850,000</u>	<u>\$38,202,000</u>
Liabilities and Fund Balances				
Accounts payable and accrued expenses	\$ 350,000	\$ 225,000	—	\$ 575,000
Deferred amounts (Note 6)				
Unrestricted	50,000	—	—	50,000
Restricted	1,600,000	2,915,000	—	4,515,000
Long-term debt (Note 4)	—	900,000	—	900,000
Total liabilities	<u>2,000,000</u>	<u>4,040,000</u>	<u>—</u>	<u>6,040,000</u>
Fund balances				
Unrestricted				
Designated by the governing board for long-term investment	6,200,000	—	—	6,200,000
Undesignated	1,012,000	—	—	1,012,000
	<u>7,212,000</u>	<u>—</u>	<u>—</u>	<u>7,212,000</u>
Restricted—nonexpendable	—	—	\$2,850,000	2,850,000
Net investment in plant	—	22,100,000	—	22,100,000
Total fund balances	<u>7,212,000</u>	<u>22,100,000</u>	<u>2,850,000</u>	<u>32,162,000</u>
Total liabilities and fund balances	<u>\$9,212,000</u>	<u>\$26,140,000</u>	<u>\$2,850,000</u>	<u>\$38,202,000</u>

EXHIBIT 13B
Sample Zoological and Botanical Society
Statement of Support and Revenue, Expenses,
Capital Additions, and Changes in Fund Balances
Year Ended December 31, 19X1

	Operating Funds		Total	Plant Funds	Endowment Funds	Total All Funds
	Unrestricted	Restricted				
Support and revenue						
Contributions and bequests	\$ 550,000	\$1,045,000	\$1,595,000	—	—	\$ 1,595,000
Fees and grants from governmental agencies	—	1,200,000	1,200,000	—	—	1,200,000
Admission charges	1,300,000	—	1,300,000	—	—	1,300,000
Membership dues	350,000	—	350,000	—	—	350,000
Endowment and other investment income	420,000	90,000	510,000	—	—	510,000
Net gain realized on investments	180,000	15,000	195,000	—	—	195,000
Auxiliary activities	3,000,000	—	3,000,000	—	—	3,000,000
Total support and revenue	5,800,000	2,350,000	8,150,000	—	—	8,150,000
Expenses						
Program services						
Animal collections and exhibits	2,742,000	1,825,000	4,567,000	\$ 440,000	—	5,007,000
Educational activities	350,000	135,000	485,000	42,000	—	527,000
Conservation and public service	60,000	90,000	150,000	14,000	—	164,000
Research activities	220,000	300,000	520,000	50,000	—	570,000
Membership activities	78,000	—	78,000	6,000	—	84,000
Auxiliary activities	1,800,000	—	1,800,000	216,000	—	2,016,000
Total program services	5,250,000	2,350,000	7,600,000	768,000	—	8,368,000

Supporting services									
General administration	530,000	—	530,000	24,000	—	—	—	—	554,000
Fund raising	80,000	—	80,000	8,000	—	—	—	—	88,000
Total supporting services	610,000	—	610,000	32,000	—	—	—	—	642,000
Total expenses	5,860,000	2,350,000	8,210,000	800,000	—	—	—	—	9,010,000
Excess (deficiency) of support and revenue over expenses before capital additions	(60,000)	—	(60,000)	(800,000)	—	—	—	—	(860,000)
Capital additions									
Contributions and bequests	—	—	—	1,030,000	\$ 20,000	—	—	—	1,050,000
Investment income	—	—	—	150,000	—	—	—	—	150,000
Net gain realized on investments	—	—	—	100,000	110,000	—	—	—	210,000
Total capital additions	—	—	—	1,280,000	130,000	—	—	—	1,410,000
Excess (deficiency) of support and revenue over expenses after capital additions	(60,000)	—	(60,000)	480,000	130,000	—	—	—	550,000
Fund balances at beginning of year	7,428,000	—	7,428,000	21,384,000	2,800,000	—	—	—	31,612,000
Transfers									
Equipment acquisitions and principal debt service payments	(236,000)	—	(236,000)	236,000	—	—	—	—	—
Realized gains on endowment funds utilized	80,000	—	80,000	—	(80,000)	—	—	—	—
Fund balances at end of year	\$7,212,000	—	\$7,212,000	\$22,100,000	\$2,850,000	—	—	—	\$32,162,000

EXHIBIT 13C

Sample Zoological and Botanical Society**Statement of Changes in Financial Position****Year Ended December 31, 19X1**

	<i>Operating Funds</i>	<i>Plant Fund</i>	<i>Endowment Funds</i>	<i>Total All Funds</i>
Resources provided				
Excess (deficiency) of support and revenue over expenses before capital additions	\$ (60,000)	\$ (800,000)	—	\$ (860,000)
Capital additions				
Contributions and bequests	—	1,030,000	\$ 20,000	1,050,000
Investment income	—	150,000	—	150,000
Net gain realized on investments	—	100,000	110,000	210,000
Excess (deficiency) of support and revenue over expenses after capital additions	(60,000)	480,000	130,000	550,000
Items that do not use (provide) resources				
Provision for depreciation	—	800,000	—	800,000
Net gain realized on investments	(195,000)	(100,000)	(110,000)	(405,000)
Issuance of long-term debt	—	900,000	—	900,000
Increase in deferred amounts	200,000	350,000	—	550,000
Proceeds from sales of investments	3,200,000	1,270,000	900,000	5,370,000
Total resources provided	<u>3,145,000</u>	<u>3,700,000</u>	<u>920,000</u>	<u>7,765,000</u>
Resources used				
Purchases of building and equipment	—	1,480,000	—	1,480,000
Reduction of long-term debt	—	36,000	—	36,000
Purchases of investments	2,861,000	2,372,000	848,000	6,081,000
Increase in accounts and pledges receivable	80,000	30,000	—	110,000
Increase in inventories	8,000	—	—	8,000
Decrease in accounts payable and accrued expenses	10,000	20,000	—	30,000
Total resources used	<u>2,959,000</u>	<u>3,938,000</u>	<u>848,000</u>	<u>7,745,000</u>
Transfers				
Equipment acquisitions and principal debt service payments	(236,000)	236,000	—	—
Realized gains on endowment funds utilized	80,000	—	(80,000)	—
Total transfers	<u>(156,000)</u>	<u>236,000</u>	<u>(80,000)</u>	<u>—</u>
Increase (decrease) in cash	<u>\$ 30,000</u>	<u>\$ (2,000)</u>	<u>\$ (8,000)</u>	<u>\$ 20,000</u>

EXHIBIT 13D

Sample Zoological and Botanical Society

Notes to Financial Statements*

December 31, 19X1

Note 1—Summary of Significant Accounting Policies

Note 2—Investments

Note 3—Plant Assets and Depreciation

Note 4—Long-Term Debt

Note 5—Pension Plan

Note 6—Changes in Deferred Restricted Amounts

Note 7—Functional Allocation of Expenses

Note 8—Commitments

Note 9—Collections

The note should disclose the following:

- a.* Capitalization basis or a statement that collections are not capitalized.
- b.* Policy on accounting for current year's purchased and donated collections.
- c.* The nature and the cost, or contributed value, of current year accessions and the nature of and proceeds from deaccessions.

* For suggested comments in each area of note disclosure above, see example included in comprehensive set of Notes to Financial Statements for exhibit 1, paragraph .129.

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The division gratefully acknowledges the contributions made to the development of this statement of position by Franz Hoge, John McLaughlin, Joseph Nehila, John O'Leary, James Ratliff, Vincent Russo, and Frank Van Morrelgem.

➤➤➤ *The next page is 18,705.* ←➤➤➤

Section 10,260

Statement of Position 79-1

Accounting for Municipal Bond Funds

January 15, 1979

[Proposal to the Financial Accounting Standards Board to Amend AICPA Industry Audit Guide, Audits of Investment Companies]

NOTE

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA subcommittees or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA subcommittee or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the subcommittee or task force believes would be in the public interest.

.01 The AICPA Industry Audit Guide (audit guide), *Audits of Investment Companies*, as amended, notes that "changes in the rules, regulations, practices, and procedures of the investment company industry have been frequent and extensive in recent years" and that "further changes are under consideration." A recent development in the investment company industry is the municipal bond fund (or tax-exempt bond fund) in corporate form made possible by the Tax Reform Act of 1976. For the first time, the law allows an investment company organized in corporate form to distribute tax-free income to its shareholders. Before the 1976 Reform Act, two forms of investment companies that specialized in municipal bonds were unit investment trusts and limited partnerships.

.02 A tax-exempt municipal bond fund is an investment company that invests principally in municipal bonds. It may be in the form of a management investment company or a unit investment trust. Municipal bonds are obligations of local governments (such as state, county, and city), and the interest paid on those bonds is exempt from federal income tax. The interest on certain of those bonds may also be exempt from state and local income tax.

.03 This proposed addition to the audit guide presents the committee's views on accounting and reporting matters and other considerations relating to municipal bond funds. While the discussion of taxes and distribution policies refers specifically to municipal bond funds in corporate form, the discussion of valuation and other matters applies to municipal bond funds in corporate form, partnership form, and unit investment trusts.

DEFINITION OF AND MARKET FOR MUNICIPAL BONDS AND NOTES

Municipal Bonds

.04 Municipal bonds are usually issued to obtain funds for a variety of public purposes, including the construction of a wide range of public facilities such as airports, bridges, highways, housing, hospitals, mass transportation, schools, streets, and water and sewer works. Municipal bonds may also be issued to refund outstanding obligations, obtain funds for general operating expenses, and obtain funds to lend to other public institutions and facilities.

.05 Industrial development bonds are issued by or on behalf of public authorities to obtain funds to finance privately operated industrial or commercial facilities. These obligations may be classified as municipal bonds, provided that the interest paid on them is exempt from federal income tax.¹

.06 The two principal classifications of municipal bonds are general obligation bonds and revenue bonds. General obligation bonds represent the issuer's unqualified pledge, based on its faith, credit, and taxing power, to pay principal and interest when due. Revenue bonds are payable from the revenues derived from a particular class of facilities or from other specific revenue sources. Tax-exempt industrial development bonds are usually revenue bonds and generally do not carry the pledge of the credit of the issuer.

¹ See Internal Revenue Code, section 103.

.07 The yields on municipal bonds depend on a variety of factors, including market conditions, maturity date, and ratings assigned to the issue.

Municipal Notes

.08 Municipal notes generally mature in less than three years. They are usually designated as tax, revenue, or bond anticipation notes because they are redeemable on receipt of anticipated taxes or revenue or on refinancing from the proceeds of municipal bonds. They include short-term tax-exempt project notes issued by public housing or urban renewal agencies of local communities, with payment of principal and interest guaranteed by the United States government.

Market

.09 There are estimated to be more than 40,000 issuers and well over one million issues of municipal bonds, counting each maturity as a separate issue. The bonds are traded in a dealer market in which little published price information exists. As a result, new issues of municipal bonds are usually sold by competitive bids. Subsequent market quotations for municipal bonds may be obtained from dealers in those securities. If there is little trading activity or if a thin market exists, dealer quotations may not indicate the prices at which a municipal bond may be bought or sold.

PORTFOLIO INVESTMENTS

Valuation

.10 In considering the values assigned to municipal bonds, the fund and its auditor should follow the direction given in the audit guide for the valuation of over-the-counter securities:

A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker/dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any one of these policies is considered to be acceptable if *consistently* applied. . . .

Ordinarily, quotations for an over-the-counter security should be obtained from more than one broker/dealer unless available from an established market-maker for that security, and quotations for several days should be reviewed. In all cases, the quotations should be from *unaffiliated persons*. . . .

Where quotations appear questionable, consideration should be given to valuing the security at "fair value as determined in good faith by the board of directors" [emphasis added].²

.11 In addition, the auditor is provided with the following guidance:

In the case of over-the-counter securities for which quotations were not available from published sources, the auditor should consider obtaining quotations as of the valuation date from *more than one independent source*. . . . If the auditor is not fully satisfied with valuation date results, he may wish to obtain further quotations at a subsequent date or dates or consider having the security valued by the board of directors [emphasis added].³

Determining Market Value

.12 A fund may obtain quoted bid and asked prices directly from dealers. If possible, the fund should obtain prices from a dealer who maintains a market for the issue. If this is not possible, quotations should be obtained from more than one dealer. The portfolio should be valued consistently, using either the bid price or the mean between bid and asked prices as described in the fund's prospectus.

.13 A number of funds have engaged bond dealers or other pricing services to value their portfolios for a fee. This service includes obtaining daily quotations from various dealers and selecting those quotations considered to be most indicative of the market value of the issue. A pricing service may but need not be an expert appraiser of municipal bonds, but it must be able to identify those dealers who are market-makers for an issue and in a position to determine value.

.14 The fund's management is responsible for determining values of portfolio securities in accordance with the fund's policies. Accordingly, if an agent is used for this purpose, the fund must be satisfied that control procedures, whether maintained by the fund or by the pricing service, provide reasonable assurance that material pricing errors would be prevented or detected. Such control procedures might include:

- Checks employed by the pricing service in obtaining daily quotations.
- Verifying daily changes of individual securities prices in excess of a stipulated percentage.

² *Audits of Investment Companies* (New York: AICPA, 1977), pp. 34-35.

³ *Audits of Investment Companies*, pp. 46-47.

- Verifying dealer quotations with other dealers on a test basis.

.15 In evaluating internal accounting controls, the auditor might consider obtaining independent quotations from dealers or visiting the pricing service's facilities to review the procedures used in obtaining daily quotations, or both. If the auditor considers the internal accounting control to be weak, he should expand the scope of his work as he deems necessary.

Fair Value and Matrix Pricing Methods

.16 Municipal bonds for which market quotations are not readily available or for which the fund believes market quotations may not be indicative of the market value of the issue should be valued at fair value. Fair value is determined by the board of directors of a management investment company. Fair value is determined by the sponsor or trustee of a unit investment trust, and/or other party having such responsibility under the trust agreement. For those determinations, matrix pricing or pricing based on reliable quotations of similar securities may be used. In determining fair value, the SEC's Codification of Financial Reporting Policies on the subject, especially Secs. 404.03 and 404.04 (ASRs 113 and 118), should be considered.

.17 The auditor should also consult these accounting series releases as well as the audit guide for guidance on reporting on financial statements where a material portion of the securities are valued "in good faith." However, the auditor will usually find that he is able to satisfy himself that the range of possible values of municipal bonds for which reliable quotations are not readily available would not have a significant effect on the fairness of presentation of the financial statements in conformity with generally accepted accounting principles; in which case, he could express an unqualified opinion.

.18 A mathematical technique known as matrix pricing uses market data available for the issue and similar issues without exclusive reliance on quoted market prices in determining securities valuations.⁴ This method, when used by a fund, results in a "fair value" determination. Accordingly, the auditor's pro-

⁴ Matrix pricing uses electronic data processing techniques to determine valuations for normal institutional-size trading units of debt securities without exclusive reliance on quoted prices. The use of data processing techniques enables one to consider factors such as the issue's coupon interest rate, maturity, and rating by a service and those of similar issues for which quoted prices are available to develop a calculation of what the current market yields would be for the issue in question. Those techniques may also consider market indexes and other market data.

cedures for examining value determined by using matrix pricing should be the same as those applied with respect to any other fair values, as discussed in paragraphs .12 through .17, above.

“When Issued” Securities

.19 Municipal bond funds buy securities on a “when issued” basis more often than most other types of funds. A municipal securities underwriter solicits expressions of interest in a proposed issue and sends a “when issued” priced confirmation against which delivery is made at a later date when the terms of the issue are known. The securities will normally begin trading on a “when issued” basis at the time such confirmation is issued and begin trading as if they had been issued a few days before the closing date. For federal income tax purposes, the holding period of the securities does not begin until they are issued.⁵

.20 While securities offerings have been aborted after “when issued” trading begins, these situations are rare. The asset and liability relating to a “when issued” security should be recorded when the priced transaction confirmation is issued, and the investment should be valued thereafter. Because the securities do not earn interest until the settlement date, they should be identified in the financial statements. The same accounting methods should be used for securities purchased under a delayed delivery contract under which the managing underwriter agrees to deliver securities to purchasers at later specified dates.

Portfolio Insurance

.21 A number of municipal bond funds, primarily those organized as unit investment trusts with fixed portfolios, arrange for insurance that guarantees the collection of principal and interest when due. The insurance normally applies to portfolio securities only while they are owned by the fund, and its coverage is not transferable to a purchaser of the security. This arrangement differs from those in which the issuer of the securities acquires the insurance, making the insurance feature an element of the security and transferable on changes in ownership. If the insurance applies to the fund’s portfolio only, it does not have any measurable value in the absence of default of the underlying securities or indications of the probability of such default.

.22 Probability of default may be indicated if the market value of a bond held by the fund declines significantly and the

⁵ I. T. 3721, 1945 C. B. 164, modified by Rev. Rul. 57-29, 1957-1 C. B. 519.

decline appears to be related to the credit worthiness of the issuer. Problems with respect to credit worthiness may be recognized through comparison with market values of similar securities or by a downgrading of credit ratings.

.23 Valuation of bonds that are held in an insured portfolio and that are in default or for which the probability of default is indicated requires a "fair value" determination as described in the audit guide (pages 35-37) and as further discussed in paragraph .16. Among the factors that should be considered in making this "fair value" determination are the terms of the insurance policy, the intention and ability of the fund to hold the bonds until maturity, and the ability of the insurer to perform under the policy in the event of default.

.24 Proceeds of insurance in place of defaulted interest are exempt for federal income tax purposes.⁶

.25 Insured securities that have been valued as provided in paragraph .23 should be identified in the financial statements as being so valued. Disclosure should also be made of the intention of the fund to hold the securities until maturity in order to realize the benefits of the insurance.

Presentation

.26 Municipal securities should be grouped either by state or municipality within the state or by purpose of issue, whichever is more meaningful. This grouping will also satisfy regulation S-X requirements that investments be classified by type of business.

.27 Although not required, bond ratings of the portfolio of investments are often disclosed. If the auditor has not checked the ratings against published sources, they should be identified as unaudited.

.28 The valuation methods used by the fund should be disclosed in the financial statements.

TAX AND OTHER CONSIDERATIONS

Qualification as a Regulated Investment Company

.29 To enjoy the benefits of paying tax-free dividends to shareholders, a municipal bond fund taxable as a corporation

⁶ Rev. Rul. 76-78.

must first qualify as a regulated investment company.⁷ Because the Internal Revenue Code states that gross income excludes tax-exempt income, such a fund must pay particular attention to meeting requirements in the following respects:⁸

- a. Section 851(b)(3) of the code requires that in order to be qualified as a regulated investment company, less than 30 percent of a fund's gross income may be derived from gains (disregarding losses) from the sale or other disposition of securities held for less than three months. Because the amount of taxable income realized by a municipal bond fund is usually a small percentage of its total income, the base used to determine the effect of the three-month test is usually very small. Consequently, a municipal bond fund taxable as a corporation with a small amount of taxable income may lose its right to qualify as a regulated investment company if it realizes any gains from the sale of securities held for less than three months.⁹
- b. If a municipal bond fund realizes taxable income, it is usually a relatively small amount. Nevertheless, 90 percent of that amount as well as 90 percent of tax-exempt income must be distributed. Declaring dividends in proportion to taxable and tax-exempt income may prevent an inadvertent under-distribution of taxable income.¹⁰

.30 Because premiums paid on purchases of obligations of a state, territory, or possession of the United States, or their political subdivisions, must be amortized for federal income tax purposes, most funds have chosen to amortize those premiums for book purposes. Original issue discount on tax-free bonds is generally amortized periodically for book and tax purposes.

.31 Because investment companies carry securities at value, amortization of premium or discount has no effect on net asset value. Amortization of bond premium results in a decrease in interest income with a corresponding increase in unrealized

⁷ Tax-exempt unit investment trusts are not generally organized as associations taxable as corporations for federal income tax purposes. Interest exempt from federal income tax retains that status when distributed to unit holders by such trusts.

⁸ The tax considerations described herein are as of the date of issuance of this statement of position. The reader should determine whether subsequent changes have been effected in the pertinent provisions of the Internal Revenue Code.

⁹ The Revenue Act of 1978 resolved this problem by providing that "gross income" for purposes of the 90 percent and 30 percent tests includes tax-exempt interest. In addition, the act disallows any loss recognized within thirty-one days of the date of purchase of shares in a tax-exempt mutual fund to the extent of any tax-exempt interest dividend received by a shareholder.

¹⁰ See note 9.

appreciation of investments and vice versa for amortization of bond discount. As a result, a policy of amortization may affect net investment income but would not affect total income from investments (net investment income plus realized and unrealized gains and losses). The accounting policy for amortization should be disclosed in the financial statements.

.32 For determining the amortization of premium on tax-exempt securities, the Internal Revenue Service has ruled (Rev. Rul. 60-17) that bond premium in excess of the call price, if any, must first be amortized to the earliest call date and the basis of the bond reduced accordingly. A remaining excess premium over a subsequent call price must be amortized to that subsequent call date. For those purposes, the remaining excess premium at a point in time is the total premium (that is, amount paid in excess of maturity value) reduced by previous amortization to previous call dates. Finally, the portion of the premium equivalent to the difference between the last call price and the maturity value is amortized over the period from the last call date to maturity.

Equalization

.33 Funds that do not declare dividends daily may use equalization accounting, as described in chapter 2 of the audit guide. A municipal bond fund that realizes a significant amount of taxable income (usually interest on investments in short-term securities) should allocate equalization debits and credits between undistributed tax-exempt income and taxable income.

.34 In defining earnings and profits of a municipal bond fund, I. R. C. sec. 852(c) and Treas. Reg. 1.852-5(b) state that "earnings and profits . . . for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year." The result may be taxation of a distribution of income equalization credits as ordinary income, as illustrated below.

	<i>Book Undistributed Income</i>	<i>Tax Basis Earnings and Profits</i>	
		<i>Current</i>	<i>Accumulated</i>
Tax-exempt interest income	\$100,000	\$100,000	\$100,000
Expenses	(16,000) ¹		(16,000)
Income equalization credits (net)	12,000		
Balance	96,000	100,000	84,000
Dividends paid ²			
Exempt-interest dividends	84,000 ³	84,000	84,000
Ordinary dividends	12,000 ⁴	12,000	—
Total dividends	96,000	96,000	84,000
Undistributed income at year end	— ⁵	\$ 4,000	—

¹ Not deductible from current earnings and profits (Treas. Reg. 1.852-5(b)).

² Based on the assumption that the fund's policy is to distribute all its net equalization credits.

³ Exempt-interest dividend = \$84,000 (\$100,000 - \$16,000).

⁴ Distribution in excess of exempt-interest dividend may be taxed as ordinary income (Treas. Reg. 1.852-5(b)).

⁵ Based on the assumption of a dividend payment on the last day of each month. The undistributed balance of current earnings and profits has no federal income tax significance since the fund has distributed its net tax-exempt income (I. R. C., sec. 852).

Distribution Requirements

.35 The Tax Reform Act of 1976 provides that a regulated investment company that meets certain tests in addition to those enumerated above may pass tax-exempt interest through to its shareholders as "exempt-interest dividends."¹¹ A dividend qualifies as an exempt-interest dividend only if—

- a. At the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the regulated investment company consists of certain tax-exempt government obligations.
- b. The dividend is designated by the regulated investment company as an exempt-interest dividend in a written notice mailed to its shareholders not later than forty-five days after the close of its taxable year.

.36 If a fund is disqualified from treating distributions as exempt-interest dividends, it may still qualify as a regulated investment company if it meets the other applicable tests.

¹¹ Tax-exempt unit investment trusts are not generally organized as associations taxable as corporations for federal income tax purposes. Interest exempt from federal income tax retains that status when distributed to unit holders by the trusts.

Distribution Policies

.37 Municipal bond funds whose investment policies require that 100 percent of their assets be invested in tax-exempt securities realize only tax-exempt income except for net gains realized on the sale of investments, which are taxable.

.38 In addition to following the requirements prescribed by the code, a municipal bond fund must also consider the tax effect on its shareholders in deciding on its distribution policies. Because gains realized on redemption of capital shares are taxable to the redeeming shareholders, dividends from net investment income are frequently declared daily in order to maximize the amount received by the redeeming shareholder as tax-exempt income. Dividends are usually paid quarterly or monthly, but redeeming shareholders may receive unpaid dividends at the time of redemption.

Allocation of Expenses

.39 The code requires that a municipal bond fund's allowable deductions be allocated between its taxable and tax-exempt income. Capital gains are excluded from this calculation. The only acceptable basis for allocation appears to be the ratio of tax-exempt income to gross investment (tax-exempt plus taxable) income. The required amortization of premium on tax-exempt bonds must be allocated to the tax-exempt income.

TRANSITION

.40 An accounting change to adopt the provisions of this statement of position should be made prospectively. The change should be made in financial statements issued subsequent to the date of this statement of position. Disclosures should be made in the financial statements in the period of change in accordance with paragraph 17 of APB Opinion 20.

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Section 10,270**Statement of Position 79-2
Accounting by Cable
Television Companies***

March 12, 1979

[Proposal to the Financial Accounting Standards Board]**NOTE**

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

INTRODUCTION

.01 Cable television (CATV) companies have developed diverse specialized industry accounting practices over a period of years, with the result that their financial statements lack comparability. This statement of position summarizes CATV companies' current specialized industry accounting practices. A study of those accounting practices by the AICPA Accounting Standards Division indicates a need for clarification and narrowing of alternative accounting practices within the industry.

GENERAL BACKGROUND

.02 Cable television systems receive television signals, which are amplified and distributed to the premises of subscribers,

* See also FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, November 1981, and FASB Statement No. 63, *Financial Reporting by Broadcasters*, June 1982.

usually over a community-wide coaxial cable distribution network. The signals originate from local and distant television broadcasting stations and are received by the CATV system by means of high antennas, microwave relay, or satellite. CATV systems may also distribute programs that originate in the systems. "Pay cable" service, consisting primarily of uncut and uninterrupted movies and sporting events, has been initiated relatively recently but is already generally available.

.03 CATV systems typically distribute signals of the three national TV networks and, to the extent permitted by Federal Communications Commission regulations, signals of independent and educational TV stations (UHF and VHF) and FM radio stations. The systems generally have a capacity of twelve to twenty TV channels, although some newer systems provide more. Many CATV systems require the attachment of a converter to the subscriber's set.

.04 The copyright law (Public Law 94-553) defines a cable TV system as follows.

A "cable system" is a facility, located in any state, territory, trust territory, or possession, that in whole or in part receives signals transmitted or programs broadcast by one or more television broadcast stations licensed by the FCC, and makes secondary transmission of such signals or programs by wires, cables, or other communication channels to subscribing members of the public who pay for such services.

.05 The copyright law requires cable systems to pay royalty fees computed on the basis of specified percentages of the gross receipts from subscribers to the cable service for the basic service of secondary transmission.

.06 For operational and accounting purposes, a cable TV system may include one or more communities and may operate under one or more franchises granted by the governing authorities of the city, county, or state served by the system. Franchises are for a stated term and contain various conditions and

limitations, which frequently include prescribed maximum service subscription fees, payment of fees to the local government, conditions of service, including provision of a minimum number of channels, and time limitations on specified construction. Failure to comply with the conditions and limitations of a franchise may give the granting authority the right to terminate the franchise and may result in lawsuits for collection of damages.

.07 The cable TV plant required to render service to the subscriber includes the following equipment:

- a. *Head-end*—includes the equipment used to receive signals of distant TV or radio stations, whether directly from the airwaves or from a microwave relay system. It also includes the studio facilities required for operator-originated programming, if any.
- b. *Cable*—consists of cable (in the past, usually coaxial cable) and amplifiers (which maintain the quality of the signal) covering the subscriber area, either on utility poles or underground.
- c. *Drops*—consist of the hardware that provides access to the main cable, the short length of cable that brings the signal from the main cable to the subscriber's TV set, and other associated hardware, which may include a trap to block particular channels.
- d. *Converters and descramblers*—devices attached to the subscribers' TV sets when more than twelve channels are provided or when special services are provided, such as "pay cable" or two-way communication.

.08 The construction period of a cable TV system varies with the size of the franchise area, density of population, and difficulty of physical construction. The construction period is not completed until the head-end main cable and distribution cables are installed, and includes a reasonable time to provide for installation of subscriber drops and related hardware. During the construction period many system operators complete installation of drops and begin to provide service to some subscribers in some parts of the system while construction continues. Providing the signal for the first time is referred to as "energizing" the system. The period from the first earned subscriber revenue until the end of this construction period is referred to as the "prematurity period" in subsequent sections of this statement.

Some system operators will construct the better portions of the franchise area and allow the system's operations to develop before extending it, well after the end of the first major construction period, to more marginal areas.

.09 Special circumstances in different franchises will require different planning; the variety of plans would include the following typical franchise development and construction plans:

- a. Small franchise, characterized by the absence of free television signal. The construction period is short and the entire system is energized at one time near the end of the construction period.
- b. Medium-size franchise, characterized by some direct competition from free television and a more extensive geographical franchise area lending itself to incremental construction, with some parts of the system energized as construction progresses.
- c. Large metropolitan franchise, characterized by heavy direct competition from free television and fringe area signal inadequacy, high cost, and difficult construction, with many parts of the system energized as construction progresses.

The length of the prematurity period varies with these circumstances and with the company's construction plan. It might range from less than a month to six months in a small marketing area with under 5,000 homes, one year in a medium-size area of 25,000 to 30,000 homes, or two years or more in a large urban market.

.10 A substantial investment is required to provide for the following costs of a cable TV system:

- a. Franchise acquisition costs.
- b. Cost of physical facilities (see paragraph .07), including cost of labor for erection, installation, interest on construction in progress, and construction overhead.
- c. Costs relating to the cable TV system and signal, such as interest on previously capitalized costs, property taxes, pole rental, and microwave charges, which may be incurred both before and after the first subscriber hookup.
- d. Other operating costs (in excess of any revenues) incurred during the construction period and before sufficient subscribers are obtained to achieve break-even operations.

If the franchise requires underground construction, construction costs and investment are substantially increased.

.11 Cable TV operators lease space on telephone or utility poles or in underground ducts. Pole attachment agreements typically have an initial term of one to five years and thereafter are terminable by either party on relatively short notice.

.12 The principal source of cable TV revenue is the monthly subscription fee for primary connections to subscribers. Additional revenues are received (a) from subscribers for secondary connections and connection charges, (b) from the sale of local advertising or from leasing time on unused channels, and (c) from pay cable services.

CURRENT INDUSTRY ACCOUNTING PRACTICES

Cable TV Investment

.13 The cost of materials, labor, and construction overhead is included in the cost of the cable TV plant. Cable TV companies have not uniformly capitalized interest during construction. However, the predominant practice among cable TV companies whose securities are publicly held has been to capitalize interest during construction and to include the capitalized costs in cable TV plant costs. Depreciation of new cable TV plant is usually computed using the straight-line method over periods that vary from ten to fifteen years.

.14 Initial subscriber installation costs, which include the material, labor, and overhead costs of the drop, are capitalized and depreciated over periods similar to or shorter than those used for cable TV plant. The costs of subsequently disconnecting and reconnecting subscribers typically are charged to expense. In addition, some companies have received revenues of the nature of payments in aid of construction from developers and have credited such amounts to the plant account.

.15 Except in the smallest systems, it is usually possible to deliver programming to portions of the system (energize the system) and obtain some revenues before construction of the entire system is complete. Thus, virtually every cable TV system experiences a prematurity period during which it is receiving some revenue while continuing to incur substantial costs related to the establishment of the total system. In general, the larger the city served by the cable TV system, the longer this period will be.

.16 Many different methods are used to account for costs and revenues during this prematurity period, although virtually all companies whose securities are publicly held defer such costs in some manner. Practices followed in accumulating the net costs deferred vary widely. Some companies defer all costs, including general and administrative, before maturity; some companies defer only operating costs; others defer only certain specified costs. Some companies depreciate cable TV plant during this period and others do not. Some reduce the deferred costs by the revenues recorded and others do not. Finally, although deferred costs are subject to a recoverability test, recoverability is measured in different ways.

.17 Accounting conventions for the determination of the maturity date, at which time deferral ceases and amortization of deferred costs begins, vary significantly within the industry. Some companies define maturity on the basis of the time elapsed since energizing the system, which varies from eighteen months to three years; others define maturity in terms of the number of subscribers connected; and still others use break-even operations as maturity. The break-even point is sometimes determined on a cash basis and sometimes on an accrual basis. Some companies use the actual break-even point and others use the originally budgeted break-even point.

.18 Deferred costs are usually amortized on the straight-line method (a) over periods of five to ten years or (b) over the estimated useful life of the cable TV system.

.19 Some companies separately defer marketing cost during the period before maturity and amortize them over a shorter period, such as three years.

Franchise Costs

.20 The costs of original franchise applications are generally deferred until the franchise has been granted and it is determined that the franchise will be developed. Costs of unsuccessful franchise applications and abandoned franchises are charged to expense. Costs of successful applications are amortized on bases similar to those for purchased franchises (paragraph .22).

.21 Purchased franchises are accounted for in diverse ways. Some companies allocate costs to purchased franchises in proportion to their fair value. Others allocate any excess of acquisition cost over the fair value of tangible and other identifiable

intangible assets acquired, less liabilities assumed, to franchises. Some treat the excess as the cost of franchises and goodwill without separate distinction, and others treat the excess as goodwill alone.

.22 Some companies do not amortize the cost of franchises acquired before November 1, 1970. The costs of franchises acquired on or after November 1, 1970, have been amortized, in accordance with APB Opinion 17, over periods of up to forty years. However, periods as short as five to ten years are also used; they are usually related to the remaining franchise term. The straight-line method of amortization is generally used, although other methods can be found in practice. For example, amortization may be based on the ratio of subscribers served in the period to the estimated total number of subscribers to be served in each year during the amortization period.

Hookup Revenue

.23 Companies engage in various marketing activities to obtain subscribers, some of which involve relatively expensive advertising efforts. The amounts charged by cable TV companies to subscribers for hookups vary; sometimes there is a substantial charge, sometimes there is none. Also, the revenues are accounted for in diverse ways. Many companies record them as subscriber revenues; others record them as an offset to marketing costs. In either event, companies believe hookup revenue to be incidental, either because it is often waived as part of a promotional campaign, or because it relates more to the marketing effort involved than to the costs of hooking up new subscribers. During the early stages of system development, companies record hookup revenue as a reduction of deferred costs.

THE DIVISION'S CONCLUSIONS

Accounting During the Prematurity Period of a Cable TV System

.24 The accounting standards division believes that recovery of the investment in a cable TV system (paragraph .10) is usually predictable and, accordingly, that costs incurred during construction before the first subscriber hookup may be capitalized. In addition, since major construction activity normally continues after the first subscriber hookup, a portion of certain costs relating to the cable TV system and signal should usually

continue to be capitalized. Furthermore, the division believes that the most theoretically appropriate, systematic, and rational allocation of capitalized plant would result from a computation that attempts to approximate depreciation on the basis of total "subscriber months" over the life of a system. For example, if a system were expected to have an average of 1,000 subscribers over its 180-month depreciation life and had achieved 300 subscribers, current monthly depreciation would be 300/180,000 of the cost of the system.

.25 The following paragraphs contain the division's recommendations for conforming accounting practice within the industry while implementing the general conclusions in paragraph .24 in a practical manner:

Recoverability (paragraph .26).

Prematurity period (paragraph .27).

Cost of physical facilities (paragraph .28).

Period costs (paragraph .29).

Other capitalizable costs (paragraph .30).

Capitalization and depreciation formula (paragraphs .31-.32).

Revenues (paragraph .33).

These recommendations recognize the appropriateness of capitalization of certain costs and of lower than straight-line depreciation during the prematurity period, but, for practical reasons, they do not permit inclusion in the depreciation base of increases in estimated subscribers expected to occur after the prematurity period. Thus, in the example in paragraph .24, average number of subscribers is to be calculated using subscribers expected at the end of the prematurity period for all years after that date.

.26 *Recoverability.* An overriding consideration in reflecting incurred costs as assets is the expectation of recovery. Accordingly, circumstances must indicate that expected revenues from a cable TV system will be sufficient to cover expected operating expenses, including amortization of intangible assets and depreciation of plant. Otherwise, no additional costs should be capitalized, and an evaluation should be made to determine if a write-down to recoverable values (through operations or sale of the system) of intangible assets and previously capitalized plant is indicated.

.27 *Prematurity Period.* Before the first earned subscriber revenue, management must determine a prematurity period for

purposes of determining capitalized costs, depreciation, and amortization. This period begins with the first earned subscriber revenue. Its end will vary with circumstances at the system, but will be determined based on the company's plans for completion of its first major construction period (paragraphs .08 and .09) or achievement of a specific predetermined subscriber level at which no additional cash investments will be required for other than physical facilities and interest. Information submitted to the division indicates that there should be a presumption that the period should not be longer than two years, and that it will frequently be shorter. Only in the largest major urban markets could a longer period be reasonably justified. Once determined, the prematurity period should not be changed except under highly unusual circumstances. Inability of management to make a reasonable estimate of the prematurity period is likely to indicate either an extremely short period or uncertainty of recovery. In either case, additional costs should not be capitalized.

.28 *Cost of Physical Facilities.* Nothing in this statement (other than the discussion of lack of recoverability in paragraph .26 and the discussion of interest during construction in paragraphs .34-.35) is intended to suggest that construction costs of physical facilities, including direct labor and construction overhead, should not be capitalized in full during and after the prematurity period.

.29 *Period Costs.* During the prematurity period, subscriber-related costs and selling, marketing, and administrative expenses should be accounted for as period costs and should not be considered for capitalization. Such costs include those relating to existing subscribers such as billing and collection, bad debts, and mailings; costs of repairs and maintenance of taps and connections; franchise fees related to revenues or number of subscribers; general and administrative system costs such as salaries of the system manager and office rent; programming costs for additional channels used in the marketing effort or costs related to revenues from, or number of subscribers to, per channel or per program service; and direct selling costs (paragraph .43).

.30 *Other Capitalizable Costs.* During the prematurity period, the cable TV system is partially under construction and partially servicing current operations. Management must dis-

tinguish between costs of physical facilities (paragraph .28), costs attributable solely to current operations and their administration (paragraph .29), and the generally fixed costs relating to the cable TV system and signal, which are attributable to both current and future operations. The last category includes interest (paragraphs .34-.35) on previously capitalized tangible and intangible costs; property taxes based on valuation as a fully operating system; pole, underground duct, antenna site and microwave rental; and local origination programming to satisfy franchise requirements. The division of these costs between costs capitalized and costs expensed should be determined as described in paragraphs .31 and .32.

.31 *Capitalization and Depreciation Formula.* Based on the plans described in paragraph .27, management should estimate the number of subscribers expected during each month of the prematurity period. During the prematurity period, costs attributable to both current and future operations (paragraph .30) should be charged to expense in an amount equal to the fraction of average subscribers expected during each month to total subscribers expected at the end of the prematurity period; only the balance should be capitalized. During the same period, depreciation should be computed as the foregoing fraction applied to monthly depreciation and amortization of total anticipated capitalized costs expected on completion of the prematurity period, using the straight-line or other depreciation method normally applied by the company after the prematurity period.

.32 The division believes that an objective upper limit to the costs capitalized and a lower limit on depreciation charged under the formula in paragraph .31 is necessary to ensure that excessive costs are not capitalized and adequate depreciation is provided. Accordingly, the division believes that the estimated number of subscribers during each month of the prematurity period should reflect, on a cumulative basis, at least equal (that is, straight-line) monthly progress in adding new subscribers toward the estimate at the end of the period. Furthermore, monthly amounts charged to expense should be increased whenever it becomes clear that the actual number of subscribers is increasing at a rate faster than expected.

.33 *Revenues.* During the prematurity period, all revenues except those from hookups (paragraph .43) should be reported as system revenues, and the portion of costs, depreciation, and amortization charged to expense under the formula described in

paragraphs .31 and .32 as well as the period costs described in paragraph .29 should be included in appropriate categories of costs of services.

Interest During Construction

.34 In November 1974, the Securities and Exchange Commission issued Accounting Series Release 163,* which, broadly speaking, precludes adoption of the practice of capitalizing interest during construction by companies, other than public utilities, registered with the SEC. The Financial Accounting Standards Board is currently considering the matter of accounting for interest costs and any pronouncement issued is expected to be applicable to cable television companies.

.35 The accounting standards division believes that because of FASB's pending consideration of accounting for interest costs, it should state no conclusion at this time on the general subject of interest capitalization. However, companies that do not capitalize interest before energizing should not do so in subsequent periods (paragraphs .24 through .33).

Segmentation

.36 In certain cases, a portion of a cable TV system may be clearly distinguishable from the remainder of the system.¹ Such a portion would have most of the following characteristics:

- a. Geographical differences, such as coverage of a noncontiguous or separately awarded franchise area.
- b. Mechanical differences, such as a separate head-end.
- c. Timing differences, such as starting construction or marketing at a significantly later date.
- d. Investment decision differences, such as separate break-even and return-on-investment analyses or separate approval of the start of construction.
- e. Accountability differences, such as separate revenue and expense accounts and separate budgets and forecasts.

.37 The division believes that a portion that can be clearly distinguished from the remainder of the system should be accounted for as a separate system. Costs incurred by the remainder of the system should be charged to the portion only if they are specifically identified with the operations of that por-

* Rescinded. See Financial Reporting Release No. 1, April 15, 1982.

¹ Some cable television companies have used the word "segment" to refer to a portion of a cable TV system. In view of the use of "segment" in a different context in FASB Statement No. 14, the word "portion" has been used here.

tion. General allocations should not be used for purposes of determining portion prematurity costs that may be capitalized in accordance with the recommendations made elsewhere in this statement. Separate projections for the portion should be developed and the portion's capitalized costs should be evaluated for recoverability separately from the remainder of the system.

Purchased Franchises and Goodwill

.38 When a cable TV system is acquired in a transaction accounted for as a purchase, values should be assigned to franchises and goodwill in accordance with APB Opinion 16 and amortized in accordance with APB Opinion 17. The following examples indicate the types of analysis appropriate for cost allocation and amortization.

- a. If a single system is acquired, the values of franchise costs and goodwill ordinarily would not be separable and therefore would be assigned the same life.
- b. If a company that operates multiple systems is acquired, the several franchises acquired will have various remaining terms and prospects for renewal, and the franchises may provide for different allowable rates to be charged for the monthly service as well as other different conditions and limitations. The value of an amortization period for each franchise would have to be determined separately. Any excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired (including individual franchises) less liabilities assumed should be recorded as goodwill related to the entire operation. The amortization period for this goodwill would be determined independently of the various franchise lives.

.39 Intangible assets other than franchises and goodwill may be identified in the purchase of some cable TV systems. For example, values may be ascribed to noncancelable exclusive agreements for sporting events, to subscriber lists, or to a rate below current market for pole rental. Such assets should also be amortized in accordance with the provisions of APB Opinion 17.

Depreciation and Amortization

.40 Since costs incurred to bring a cable system to a fully operational status create a resource with a period of expected benefit not substantially different from the useful life of the

physical facilities, the division believes that the amortization period for such costs should be the same as that used to depreciate the main cable TV distribution system.

.41 A number of factors are involved in determining the proper lives for depreciation and amortization purposes. These factors include the legal franchise life, the economic useful life of the main cable television plant, and the accounting life of the main cable television plant. If the accounting life used is longer than the legal franchise life, there should be justification to support the conclusion that the unamortized assets will be recovered at the end of the franchise. Support for such a conclusion would include but not be limited to the ability to recover the net book value on disposal or the likely renewal of the system's franchise; the latter could be either on terms similar to or different from the original franchise. If the terms of a likely franchise renewal are expected to cause a significant diminution in value to the owner of the system, the original franchise life should be used for amortization of other assets.

.42 Once the system is fully operational, it should continue to be reviewed for recoverability as described in paragraph .26.

Hookup Revenue

.43 The division believes that hookup revenue should be allocated to systems revenue to the extent of direct selling costs, with any balance deferred and taken into income over the estimated average period that subscribers are expected to remain connected to the system.

.44 Direct selling costs include commissions, the portion of salespersons' compensation other than commissions that results in obtaining subscribers, and costs of processing documents relating to new subscribers acquired. They should not include supervisory and administrative expenses or indirect expenses such as rent and facilities costs.

.45 The cost of a subscriber connection made at a location where a previous customer had been connected to the system should be charged to expense unless the cost of the previous connection has been written off.

Programming Material

.46 The costs of programming material produced for internal use or for sale to others should be accounted for in accordance

with the provisions of the AICPA Industry Accounting Guide, *Accounting for Motion Picture Films*. Purchased program material should be accounted for in accordance with the recommendations made in the division's Statement of Position 75-5 [section 10,090], *Accounting Practices in the Broadcasting Industry*.

Accounting Principles for Regulated Industries

.47 Some states have adopted legislation that regulates CATV systems as public utilities. Cable TV systems are similar to utilities only in that they require heavy plant investment, service by "connection" for each subscriber, and are subject (in varying degrees) to regulation of subscription rates and levels of service required to maintain their franchise rights. Other aspects of cable TV systems are not similar to public utilities. There has been no identifiable consistency in the application of the rate-making process for cable TV systems; the procedures for setting utility rates, on the other hand, are similar in nature. Finally, since the operator competes with other entertainment industries, service charges sometimes are less than the authorized rates.

.48 The division believes that the addendum to APB Opinion 2 does not apply to the financial statements of cable TV companies.

Financial Statement Presentation

.49 Since a cable TV company generates its revenue through use of its property, plant, and equipment, it has few current assets as that expression is defined in terms of a one-year operating cycle. Therefore, the division believes that it is not necessary to identify current assets and liabilities separately in the financial statements. Debt maturities should be disclosed in the financial statements or related notes.

.50 Costs incurred to bring a cable TV system to a fully operational status that are capitalized under the provisions of paragraphs .24 to .33 should be classified with plant and equipment, but separately identified. Companies with systems under construction or in the prematurity period should disclose amounts capitalized during the reporting period and the ending date of the prematurity period.

Transition

.51 This statement of position should be applied in financial statements for fiscal years beginning after December 15, 1978,

although earlier application is encouraged. Accounting changes adopted to apply the recommendations of this statement of position should be made retroactively by restating the financial statements of prior periods.

.52 Companies may not have readily available the forecast information needed to make the required calculations under paragraphs .24-.33. In that event, actual historical subscriber data may be substituted for the forecast information.

.53 Companies that do not expect to have systems in the prematurity period in the future should continue their previous method of accounting for already mature systems, in accordance with APB Opinion 20, paragraph 16. For example, a single locally owned system, the owners of which expect to make no investments in additional cable TV systems, should not change its previous accounting. Systems that are subsidiaries or divisions of multiple system groups, however, should follow the accounting recommended for the group.

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Section 10,280

Statement of Position 79-3

Accounting for Investments of Stock Life Insurance Companies*

March 23, 1979

[Proposal to the Financial Accounting Standards Board to Amend AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*]

NOTE

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA committees, subcommittees, or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA committee, subcommittee, or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the committee, subcommittee, or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee, subcommittee, or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the committee, subcommittee, or task force believes would be in the public interest.

INTRODUCTION

.01 In 1972, the AICPA Insurance Companies Committee issued the industry audit guide, *Audits of Stock Life Insurance Companies* (referred to in this statement of position as "guide"). Part II of the guide, which discusses the application of generally accepted accounting principles, includes a section (pages 88 through 90) on the "Valuation of Investments and Recognition of Realized and Unrealized Gains (Losses) Thereon." That

* See also FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, June 1982.

section outlines five acceptable methods of accounting for gains or losses on the sale of equity securities.

.02 The accounting standards division believes that it is not desirable to have five alternative accounting methods for accounting for equity securities and related investment gains or losses by stock life insurance companies. Therefore, this statement of position expresses the division's conclusions on accounting for all investments and related realized and unrealized gains or losses of stock life insurance companies.¹ This statement of position also expresses the division's conclusions on accounting for real estate by stock life insurance companies, which was not discussed in the guide. This statement of position applies only to stock life insurance companies.

.03 The interests of policyholders and the public in the financial integrity of stock life insurance companies make it important that the solvency of those companies be continuously demonstrated to regulatory authorities. Consideration of those interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (statutory accounting practices²). Federal income taxation of life insurance companies is also based primarily on statutory accounting practices. The use of generally accepted accounting principles, as discussed in this statement of position, should not be construed as an indication that those accounting principles should also be used in reporting to regulatory or taxing authorities.

VALUATION OF INVESTMENTS AND RECOGNITION OF RELATED REALIZED AND UNREALIZED GAINS OR LOSSES

Discussion

.04 Under statutory accounting practices, investments in common stocks are carried at market value, preferred stocks generally are carried at cost, bonds generally are carried at amortized cost, mortgages are generally carried at unpaid principal or amortized cost if purchased at a discount or premium, and real estate generally is carried at depreciated cost. Realized investment gains or losses and changes in the carrying amount

¹ This statement of position supersedes the section in the guide on "Valuation of Investments and Recognition of Realized and Unrealized Gains (Losses) Thereon."

² Practices that have been prescribed by statute, regulation, or rule or that have been permitted by specific approval or acceptance.

of investments representing unrealized appreciation or depreciation are credited or charged to stockholders' equity.

.05 The guide states that any of the five following methods of recognizing realized and unrealized investment gains or losses could be used:

- a. Include realized gains and losses on investments in determining net income and report unrealized gains or losses as direct increases or decreases in a special stockholders' equity account.
- b. Present realized and unrealized gains and losses on equity securities and realized gains and losses on bonds in a separate statement.
- c. Include realized and unrealized gains and losses on all investments in unassigned surplus.
- d. Present realized and unrealized gains and losses on all investments in a separate statement.
- e. For subsidiaries of noninsurance companies, restate investments in equity securities from market to cost for purposes of consolidation and recognize in income the realized gains and losses on sales of securities.

Conclusions

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

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

.08 Mortgages should be accounted for at unpaid principal or amortized cost if purchased at a discount or premium unless collectibility is uncertain. Real estate investments should be accounted for at depreciated cost unless there is an impairment in

value.³ Amortization, depreciation, and other related charges or credits should be charged or credited to investment income. Charges and credits to valuation accounts should be included in realized gains and losses.

.09 Realized gains and losses on all assets held for investment (including, but not limited to, stocks, bonds, mortgage loans, real estate, joint ventures, and subsidiaries held for investment) should be included in the statement of income below operating income and net of applicable income taxes. Realized gains and losses on the sale of other assets, such as property used in the business and operating subsidiaries, should be included in the statement of income before applicable income taxes. Unrealized investment gains and losses should be recognized in stockholders' equity net of applicable income taxes and should not be included in net income.

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

.11 Valuation accounts should not be used for publicly-traded bonds, common stocks, or preferred stocks.⁴

REAL ESTATE

Discussion

.12 Under statutory accounting practices, real estate is classified as an investment regardless of its use. For real estate used in operations, rent is included in investment income and is charged to the operating departments. The guide is silent on that subject and the statutory accounting practice has gained general acceptance in the industry.

Conclusions

.13 Real estate should be classified either as an investment or as property used in the business, based on its predominant use.

³ Investments in leased assets should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*.

⁴ This paragraph is not intended to preclude the accrual of losses from uncollectible receivables when both conditions in paragraph 8 of FASB Statement No. 5, *Accounting for Contingencies*, are met.

Depreciation and other real estate operating expenses should be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rent expense should not be attributed to real estate used in the business.

TRANSITION

.14 The conclusions in this statement of position should be applied to financial statements of stock life insurance companies issued for annual and interim periods ending after July 1, 1979. Earlier application is encouraged. The conclusions in this statement of position should be applied retroactively and financial statements presented for prior periods should be restated.

ACCOUNTING STANDARDS DIVISION

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Section 10,290**Statement of Position 79-4
Accounting for Motion Picture Films***

March 26, 1979

**[Proposal to the Financial Accounting Standards Board to Amend
AICPA Industry Accounting Guide Accounting for Motion Picture
Films]****NOTE**

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA committees, subcommittees, or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA committee, subcommittee, or task force.

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To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee, subcommittee, or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the committee, subcommittee, or task force believes would be in the public interest.

INTRODUCTION

.01 The AICPA industry accounting guide, *Accounting for Motion Picture Films* (guide), discusses, in addition to other subjects, accounting for revenue from television exhibition, that is, sales of rights to permit one or more exhibitions of a film (including features, series, and specials made for television) during specified license periods. The guide concludes that

* See also FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, December 1981.

the revenue from films licensed for television should not be recognized prior to commencement of the license period and not until 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.

The guide further states that

The fifth condition regarding availability distinguishes the recommended method from the contract method in that revenue is not recognized until the right is exercisable by the licensee and all conflicting licenses have expired. Exhibition rights transferred to a licensee generally are definable by geographic market area and are marketed in a manner to avoid conflict in a given market. Conflict may exist in a market between (1) theaters and television stations, (2) network television and local stations, and (3) two or more local stations within the market area. The conflict between theatrical showing and telecasting also is recognized by the producer (or owner) of the film, who usually imposes restrictions on distribution which prohibit the licensing of the film for television for a sufficient period of time to allow for theatrical release. Because of these circumstances, the Committee has concluded that revenue from licensing of a film should be recognized in the same sequence as the market-by-market exploitation of the film and at the time the licensee is able to exercise his rights under the agreement, which would be the later of the commencement of the license period (the right then being exercisable by the licensee) or the expiration of a conflicting license (the right then being deliverable by the licensor).

.02 It has come to the attention of the division that the description of availability quoted above does not discuss restrictions on the timing of showings other than the first showing of a motion picture film under a license agreement. The effect of those types of restrictions needs to be clarified because different interpretations have developed in practice.

CONCLUSION

.03 The division believes that restrictions on timing of showings other than the first showing should not affect the recognition of revenue when there is no conflicting license preventing usage

by the licensee. This conclusion applies to restrictions on timing of subsequent showings of a feature or special and to restrictions on timing of showings of subsequent episodes of television series. This conclusion does not modify the requirement that all the conditions in paragraph .01 should be met before revenue is recognized.

.04 This statement of position amends the guide by inserting the following as the concluding sentences of the description of availability quoted above (second paragraph on page 8 of the guide):

Thus, the availability condition is met when a film may be shown for the first time under a licensing agreement. The committee has concluded that restrictions on timing of subsequent showings of the film under the same license agreement, or a contemporaneous license with the same licensee, do not affect the availability date.

TRANSITION

.05 This statement of position should be applied to all license agreements with initial availability dates after December 31, 1978.

ACCOUNTING STANDARDS DIVISION

Accounting Standards Executive Committee

(1978-1979)

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Section 10,300

Statement of Position 80-1
Accounting for Title
Insurance Companies*

January 31, 1980

[Proposal to the Financial Accounting Standards Board]**NOTE**

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

.01 The AICPA Insurance Companies Committee has reviewed existing accounting literature dealing with variances between (a) generally accepted accounting principles and (b) practices prescribed or permitted by insurance regulatory authorities, as those practices relate to title insurance companies, and has identified areas in which further clarification seems necessary. The committee has also identified certain areas that are not covered in present accounting literature.

.02 An exposure draft of a proposed statement of position on *Accounting for Title Insurance Companies* was issued for comment on May 1, 1978, and a public hearing on it was held on July 17, 1978. A second exposure draft was issued on March 16, 1979. Comments received on the exposure drafts and presentations made at the public hearing were considered in preparing this statement of position.

.03 In recent years, accountants, investors, and other users of financial statements have expressed concern over the accepta-

* See also FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, June 1982, and FASB Statement No. 61, *Accounting for Title Plant*, June 1982.

bility of accounting alternatives for similar business transactions. The accounting standards division believes that it is not desirable to have acceptable accounting alternatives in the title insurance industry. Therefore, this statement of position expresses the division's conclusions on accounting methods that should be used in the areas in which accounting alternatives exist.

.04 This statement of position applies to title insurance company financial statements that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. In addition, the section on accounting for title plant (paragraphs .25 through .40) applies to financial statements of all entities that use a title plant in their operations. Those entities include, but are not limited to, title insurance companies (underwriters), title abstract companies, and title agents.

.05 The interests of policyholders and the public in the financial integrity of the title insurance industry make it important that the solvency of title insurance companies be demonstrated to regulatory authorities. Consideration of those interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (statutory accounting practices¹). Solvency must be continuously demonstrated for a title insurance company to be permitted to offer its services to the public. Federal income taxation of title insurance companies is also based primarily on statutory accounting practices. The use of generally accepted accounting principles, as discussed below, should not be construed as an indication that those accounting principles should also be used in reporting to regulatory or taxing authorities.

PREMIUM REVENUE RECOGNITION

Discussion

.06 The title insurance business primarily involves the issuance of title insurance policies or binders to real estate owners, purchasers, and mortgage lenders, indemnifying them against loss or damage arising out of defects in, or liens on, the title to real estate. Title insurance differs from other traditional prop-

¹ *Statutory accounting practices* are practices that have been prescribed by statute, regulation, or rule, or have been permitted by specific approval or acceptance.

erty and liability insurance in that the term of the policy is indefinite and the premium is not refundable.

.07 While title insurance premiums generally are collected at the time policies are issued or within a reasonable time after issuance, practices vary within the industry regarding when the revenue is recognized as earned.

.08 Under statutory accounting practices, title insurance companies are required to defer a portion of their premium revenue based on statutory formulas, which vary by state. Unearned premiums represent a significant liability in the statutory financial statements of a title insurance company and are recognized as revenue over a relatively long period of time. The statutory method of recognizing revenue is intended to be a conservative means of providing additional protection to policyholders.

.09 Some title insurance companies include the unearned premium reserve as an additional provision for losses in their financial statements that are intended to be presented in conformity with generally accepted accounting principles. Title insurance companies usually do not charge losses against the unearned premium reserve; instead, they establish separate loss reserves for claims that have been reported.

.10 Most title insurance companies recognize the entire premium as revenue at the policy effective date when reporting in conformity with generally accepted accounting principles. The effective date of the policy can be (a) the date the real estate sale or loan is closed, (b) the date the deed or other instruments are filed, (c) the date the policy is issued, or (d) the date indicated on the policy as the effective date. Those who support the effective date as the basis for revenue recognition believe that this method produces a proper matching of costs and revenue, since most costs associated with the policy have been incurred by the time the policy becomes effective. Immediate recognition of all revenue is further justified by the fact that there is no cancellation provision or policy term. Those who support immediate recognition of the premium as revenue believe that losses on title insurance policies have occurred by the time the policies are issued and, therefore, loss reserves should be provided concurrent with revenue recognition.

.11 Some companies recognize the premium as revenue at the time a binder is given. In practice, the binder and effective dates

can vary from being almost simultaneous to being several months apart, depending on the type of real estate insured (for example, residential, commercial, or construction) and local title search procedures. Those who support the binder date as the point of revenue recognition believe that the title search has been performed as of that date, most related costs have been incurred, and title insurance is in effect. Those who support the effective date rather than the binder date as the basis for revenue recognition believe that the effective date is more conservative than the binder date, since it is not possible to determine at the time a binder is issued whether a policy will ultimately be issued.

.12 A title insurance policy may also be issued by an agent who performs the title search and is authorized to act on behalf of a title insurance company. In those circumstances, the title insurance company may be notified of the issuance of the policy some time after the effective date. It has generally been industry practice to recognize such premium revenue when reported by an agent. Others believe that an estimate should be recorded for such delayed-reported premiums.

Conclusions

.13 Revenue should be recognized as earned when the title insurance company is legally or contractually entitled to collect the premium. In most circumstances, revenue would be recognized on the effective date; however, the binder date would be appropriate if the title insurance company is legally or contractually entitled to collect the premium on the binder date.

.14 If reasonably estimable, revenue and expenses related to policies issued by agents should be recognized when the agents are legally or contractually entitled to collect the premiums, using estimates based on past experience and other sources; if not reasonably estimable, the revenue and expenses should be recognized when agents report the issuance of the policies.

LOSSES

Discussion

.15 Under existing statutory accounting practices, a provision is included in the financial statements for losses that have been reported to the company. However, there is no specific recognition (in the form of loss reserves) in the statutory financial statements for incurred but not reported losses. Statutory accounting practices, however, require that a portion of

title insurance premiums received be deferred and taken into income over a number of years. The actual number of years depends on the state in which the policy is written. That practice may be viewed as creating a reserve that is essentially available for losses inasmuch as there are no contractual provisions of the title policy that require the return of any portion of the premium.

.16 Events giving rise to a loss in the title insurance industry for the most part occur before the policy is issued, which contrasts with the typical property and liability loss in which the event giving rise to the loss occurs after the policy is issued. The exceptions to the general rule concerning prior occurrence may arise in certain special types of title coverage, such as mechanics liens coverages in construction projects, in which the events giving rise to losses may occur after the policies are issued.

.17 Industry practice in accounting for title insurance company losses under generally accepted accounting principles varies somewhat, although most companies establish liabilities for all losses on existing policies, including estimates for incurred but not reported losses. The estimates are intended to provide for the ultimate cost of settlement and are based generally on the company's historical experience adjusted for recent developments and trends.

.18 Title insurance companies may sometimes obtain the insured's mortgage, deed of trust, or fee interest in the insured's real estate in connection with the settlement of a claim. The title insurance company's ability to realize a recovery from real estate interests varies substantially as a result of differing circumstances regarding the value of the property and the status of the ownership interest acquired.

Conclusions

.19 Under generally accepted accounting principles, losses should be recognized in the financial statements at the time the related premium revenue is recognized. At that time, a provision should be made for all estimated losses that will result from the issuance of the policies, reduced by estimated recoveries. Unpaid losses, including incurred but not reported losses, should be based on the best estimate of the ultimate cost of settlement, including the effects of inflation and other social and economic factors, reduced by estimated recoveries using past experience

adjusted for current trends and any other factors that should modify past experience. Changes in loss estimates resulting from the continuous review process, and differences between estimates and ultimate payments, should be reflected in operations of the period in which the estimates are changed.

.20 Estimated recoveries on unsettled claims, such as a potential ownership interest in real estate, should be evaluated in terms of their estimated realizable value and recorded as a reduction of unpaid losses. The estimated amount of recoveries on settled claims should be reported as an asset.

.21 Property acquired in settling claims should be accounted for at the amount of cash, or its equivalent, expected to be derived from the sale of the property, net of costs such as maintenance and selling expenses required to be incurred prior to sale. Such property should be separately presented in the balance sheet and should not be classified as an investment. Subsequent reductions in the carrying amount and realized gains and losses on the sale of such property should be charged or credited to claims incurred.

.22 No conclusion has been reached on the issue of whether loss reserves should be discounted—that is, whether the time value of money should be considered in determining loss reserves. Because of the importance of that issue, the division believes that it should develop an issues paper on the subject for submission to the Financial Accounting Standards Board. Until the issue is resolved, companies that discount loss reserves or loss adjustment expenses (see paragraphs .23 and .24) should disclose that fact in their financial statements, together with the effects on the financial statements.

LOSS ADJUSTMENT EXPENSES

Discussion

.23 In the course of settling title insurance claims, a title insurance company frequently incurs expenses for outside services (primarily legal) as well as internal settlement expenses. Internal settlement expenses, which are insignificant, generally consist of fixed costs associated with a permanent employee staff handling a variety of functions, including loss adjustment. Practice varies within the industry with respect to recording those expenses. Settlement expenses are accrued by some com-

panies at the time the loss is recognized; settlement expenses are treated by others as period costs.

Conclusions

.24 Internal settlement expenses should be expensed as period costs and external settlement expenses expected to be incurred should be accrued at the time the related losses are accrued.²

TITLE PLANT

Discussion

.25 *Nature of Title Plant.* The business of issuing title insurance policies to insure the condition of title to real estate requires the gathering of all public records relating to the properties that, by law, impart constructive notice of their contents. Generally, public records are not indexed or filed according to particular parcels of property, which makes searching records for particular parcels of property a costly, complex, and inefficient process. In view of the time required and costs incurred to examine pertinent public records and abstract (summarize) their contents, title insurance companies construct or purchase an integrated and indexed collection of title records covering all parcels of real estate within a county before they commence business in the county. The title records, referred to in the industry as a title plant, represent the principal productive asset used to generate title insurance revenue.

.26 A title plant consists of (a) indexed and catalogued information for a period of time concerning the ownership of, and encumbrances on, real estate, (b) information relating to persons having an interest in real property, (c) maps, plats, and so forth, (d) copies of prior title insurance policies and reports, and (e) other documents and records. In summary, a title plant constitutes an historical record of all matters affecting title to parcels of land in a particular geographic area. The number of years covered by a title plant varies, depending on regulatory requirements and management decisions concerning the minimum information period needed to issue title insurance policies efficiently. Title plants are updated on a daily or other frequent basis by the addition of copies of documents on the status of title to specific parcels of real estate.

.27 A title plant, or an ownership interest in a title plant, is obtained either by construction or by purchase. Construction of

² See paragraph .22.

a title plant consists of (a) obtaining copies of all historical documents affecting real estate and documents relating to persons having an interest in real estate in a particular county for a specified period of time, (b) organizing and summarizing the historical information in an efficient and useful manner, (c) designing a system to store and retrieve the information, and (d) transcribing the summarized information into the storage and retrieval system. The information obtained can be maintained on a variety of media such as manually-prepared records, machine-prepared records, microfilm, microfiche, or magnetic tape and may be stored in racks, folders, cabinets, or computers. Costs incurred to construct a title plant consist principally of payroll and document copying costs and other costs directly related to title plant construction. Industry practice generally has been to capitalize title plant construction costs until, in the judgment of management, the title plant is operational. A title plant is considered operational at the time it can be used for title searches.

.28 A title plant is composed of (a) documents containing historical information relating to real estate in a particular county and (b) a system to store and retrieve the information efficiently and effectively. The historical information in a title plant is not consumed by use, is not replaced in the ordinary course of business, and has an indefinite life as long as the information is updated on a current basis. It is often necessary to search records for the earliest recorded documents in order to provide indemnification; in other instances, a title search involves reading information summarized in the most recently issued title report. Accordingly, the economic useful life of the information is indefinite and indeterminable.

.29 *Maintenance of Title Plant.* Maintenance involves the recurring activities required to update a title plant on a daily or other frequent basis. The title plant is updated by adding (a) copies of official documents, (b) updated reports on the status of title to specific parcels of real estate, and (c) records relating to security or other ownership interests. Title insurance companies presently charge maintenance costs to expense as incurred.

.30 Some believe that maintenance costs sustain the value and utility of the title plant but do not add to the asset or result in a new asset. They believe that expensing maintenance costs as incurred is consistent with the industry's general practice of

not deferring a portion of the premium and, thus, provides an appropriate matching of costs and revenue. Others believe that maintenance costs add to the value of a title plant and should be capitalized.

.31 *Storage and Retrieval.* Title insurance companies, from time to time, design or acquire new storage and retrieval systems or convert the historical information from one storage and retrieval medium to another (for example, from manually-prepared records to microfilm) in response to new technology, the need to process greater volumes of business, or the need to reduce space required to store historical information. Presently, some title insurance companies identify and capitalize as title plant the costs associated with modernization programs, while others charge the costs to expense as incurred. Some believe that such costs provide economic benefits beyond the accounting periods in which they are incurred, that the storage and retrieval systems have determinable economic useful lives, and that the costs associated with the systems should be capitalized and systematically allocated to operations over their estimated useful lives.

.32 *Sale of Title Plant.* A title insurance company may sell (a) all or a portion of a title plant and convey all or an undivided interest in ownership rights to the buyer, (b) the right to use all or a portion of a title plant, or (c) the right to copy a particular title plant. Accounting practice for those transactions varies. Some companies record the sales proceeds as revenue and do not expense a portion of the cost of the title plant, whereas other companies record the sales proceeds as revenue and expense a portion of the cost of the title plant. Some companies that offset a portion of the cost of the title plant against the sales proceeds present the resulting gain or loss as a separate item in the statement of income. In addition, some companies may consider the entire proceeds from the sale as a return of the cost of the title plant and reduce the cost of the title plant accordingly.

Conclusions

.33 *Nature of Title Plant.* A title plant is a tangible asset that is unique to the title insurance industry. If properly maintained, the historical information in a title plant has an indeterminate life and does not diminish in value with the passage of time.

.34 *Capitalization of Title Plant.* Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, should be capitalized until the title plant can be used by the company to conduct title searches and issue title insurance policies. The capitalized costs should be directly related to, and properly identified with, the activities necessary to construct the title plant. After the construction or purchase of a title plant, a company may decide to purchase or construct a title plant (backplant) that antedates the period of time covered by the existing title plant. Costs to construct a backplant must be properly identifiable to qualify for capitalization. Capitalized costs of a title plant should not be depreciated.

.35 Purchased title plants, including a purchased undivided interest in a title plant, should be recorded at cost at the date of acquisition. For a title plant acquired separately, cost should be measured by the fair value of the consideration given.³ Title plants purchased as part of a group of assets or as part of a business combination accounted for as a purchase should be accounted for in accordance with APB Opinion 16, *Business Combinations*.

.36 *Maintenance of Title Plant.* Costs incurred to maintain a title plant should be expensed as incurred.

.37 *Costs of Title Searches.* Costs incurred to perform title searches should be expensed as incurred.

.38 *Storage and Retrieval.* Costs incurred after a title plant is operational to (a) convert the information from one storage and retrieval system to another or (b) modify or modernize the storage and retrieval system should not be added to the carrying amount of the title plant; however, such costs may be separately deferred and amortized in a systematic and rational manner.

.39 *Sale of Title Plant.* A title insurance company may (a) sell its title plant and relinquish all rights to its future use, (b) sell an undivided ownership interest in its title plant, that is, the right to its joint use, or (c) sell a copy of its title plant or the right to use it. If the company relinquishes all future rights to its title plant, the amount received as consideration for the sale should be presented as a separate component of revenue, net

³ Nonmonetary transactions should be accounted for in accordance with APB Opinion 29, *Accounting for Nonmonetary Transactions*.

of the carrying amount of the title plant. If the company sells an undivided interest in its title plant, the amount received as consideration for the sale should be presented as a separate component of revenue, net of a pro rata portion of the carrying amount of the title plant. If the company sells a copy of its title plant or the right to use it, the amount received should be presented as a separate component of revenue. Ordinarily, no cost should be allocated to the sale of a copy or the right to use a title plant. However, if the value of the title plant decreases below its carrying amount as a result of the sale, the carrying amount of the title plant should be written down to its estimated net realizable value.

.40 *Impairments.* Ordinarily, a title plant has an indeterminate life and does not diminish in value with the passage of time; however, the following circumstances may indicate that its value has been impaired:

- a. Changes in legal requirements or statutory practices.
- b. Effects of obsolescence, demand, and other economic factors.
- c. Actions of competitors and others that may affect competitive advantages.
- d. Failure to update (maintain) the title plant properly on a current basis.
- e. Abandonment of a title plant or other circumstances that indicate obsolescence.

If the value of a title plant decreases below its carrying amount as a result of one or more of the foregoing or other circumstances, the title plant should be written down to its net realizable value.

VALUATION OF INVESTMENTS AND RECOGNITION OF RELATED REALIZED AND UNREALIZED GAINS OR LOSSES

Discussion

.41 Under statutory accounting practices, investments in common and preferred stocks are carried at market value, bonds generally are carried at amortized cost, mortgages are carried at unpaid principal or amortized cost if purchased at a discount or premium, and real estate generally is carried at depreciated cost. Realized investment gains or losses are credited or charged

to income. Changes in the carrying amount of investments representing unrealized appreciation or depreciation are credited or charged to stockholders' equity.

.42 The statutory method of accounting for investments is supported by the following reasoning:

- a. Carrying bonds whose value has not been permanently impaired at amortized cost is appropriate since a company that has the ability and intent to hold the investments to maturity will be able to realize face amount. Market values that reflect periodic changes in prevailing interest rates are irrelevant in valuing bonds that are expected to be held to maturity.
- b. Carrying common and preferred stocks at market is appropriate because a company has no assurance that it will receive more or less than the current market value.
- c. Including realized investment gains and losses in net income is appropriate since it is based on the realization principle. Periodic fluctuations in market value are appropriately recognized in valuing equity investments but should not be included in net income because the fluctuations do not meet the realization principle.

.43 Some believe that realized and unrealized investment gains or losses should be combined in a separate financial statement. They believe that valuation of investments under the statutory method is appropriate for the reasons stated above. However, they advocate that changes in the value of investments, whether realized or unrealized, should be presented in a separate financial statement as one combined amount. They believe that this treatment is the most meaningful since the realization of a gain or loss has an offsetting effect on the related unrealized gain or loss. Because of the materiality of the amounts and the significant fluctuations that occur, they believe that realized and unrealized gains or losses should not be included in the determination of net income because that would make net income meaningless.

.44 Some believe that realized gains and losses should be reported as an integral part of a title insurance company's results of operations because an investor's appraisal of a title insurance company's performance should include the results of realized gains and losses over a period of years.

.45 FASB Statement No. 12, *Accounting for Certain Marketable Securities*, discusses the accounting treatment to be followed by specialized industries, such as title insurance companies, with respect to investments in common and preferred stocks.

Conclusions

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

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

.48 Mortgages should be accounted for at unpaid principal or amortized cost if purchased at a discount or premium unless collectibility is uncertain. Real estate investments should be accounted for at depreciated cost unless there is an impairment in value.⁴ Amortization, depreciation, and other related charges or credits should be charged or credited to investment income. Charges and credits to valuation accounts should be included in realized gains and losses.

.49 Realized gains and losses on all assets held for investment (including, but not limited to, stocks, bonds, mortgage loans, real estate, joint ventures, and subsidiaries held for investment) should be included in the statement of income, below operating income and net of applicable income taxes. Realized gains and losses on the sale of other assets, such as property used in the business and operating subsidiaries, should be included in the statement of income before applicable income taxes. Unrealized investment gains and losses should be recognized in stockholders' equity net of applicable income taxes and should not be included in net income.

⁴ Investments in leased assets should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*.

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

.51 Valuation accounts should not be used for common stocks, preferred stocks, or publicly traded bonds.⁵

REAL ESTATE

Discussion

.52 Under statutory accounting practices, real estate is classified as an investment regardless of its use. For real estate used in operations, rent is included in investment income and is charged to the operating departments.

Conclusions

.53 Real estate should be classified either as an investment or as property used in the business, based on its predominant use. Depreciation and other real estate operating expenses should be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rent expense should not be attributed to real estate used in the business. (Property acquired in settling claims should be accounted for as discussed in paragraph .21.)

TRANSITION

.54 The conclusions in this statement of position should be applied to financial statements for fiscal years beginning after December 31, 1980. Earlier application, however, is encouraged. An accounting change to adopt the provisions of this statement of position should be made retroactively by restating the financial statements of prior periods. If information for restatement of prior periods is not available, financial statements and summaries for prior periods presented should be restated for as many consecutive periods preceding the transition date of this statement as is practicable, and the cumulative effect of applying its provisions on the retained earnings at the beginning of

⁵This paragraph is not intended to preclude the accrual of losses from uncollectible receivables when both conditions in paragraph 8 of FASB Statement no. 5, *Accounting for Contingencies*, are met.

the earliest period restated (or at the beginning of the period in which the statement is first applied if it is not practicable to restate any prior periods) should be included in determining net income of that period (see paragraph 20 of APB Opinion 20, *Accounting Changes*). Disclosures should be made in the financial statements in the period of change in accordance with paragraph 28 of APB Opinion 20.

ACCOUNTING STANDARDS DIVISION

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➤→ *The next page is 18,821.* ←➤

Section 10,310**Statement of Position 80-2
Accounting and Financial Reporting
by Governmental Units**

June 30, 1980

[Amendment to AICPA Industry Audit Guide Audits of State and Local Governmental Units.]**NOTE**

The American Institute of Certified Public Accountants has issued an industry audit guide, *Audits of State and Local Governmental Units* (1974), that presents recommendations on auditing procedures and auditors' reports and on accounting principles. This statement of position has been prepared to revise or clarify certain of the recommendations in that guide. This statement of position represents the considered judgment of the AICPA Committee on State and Local Government Accounting.

To the extent that this statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the 1974 guide. With regard 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 this 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 body responsible for setting standards for financial accounting and reporting by state and local governmental units.

Background

.01 The 1974 AICPA industry audit guide, *Audits of State and Local Governmental Units*, acknowledged *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR), a 1968 publication of the National Committee on Governmental Accounting (NCGA), as an authoritative source in the area of accounting for state and local governmental units. The guide (p. 9) states, "GAAFR's principles do not represent a complete and separate body of accounting principles, but rather are a part of the whole body of generally accepted accounting principles which deal specifically with governmental units. Except as modified in this guide, they constitute generally accepted accounting principles."

.02 In March 1979 the NCGA (now known as the National Council on Governmental Accounting) published a document entitled *Governmental Accounting and Financial Reporting Principles* (Statement 1). That document specifies that the basic general purpose financial statements of the governmental unit as a whole are combined financial statements by fund types and account groups rather than financial statements of individual funds and account groups. It also updates, clarifies, amplifies, and reorders other portions of GAAFR. Since the guide recognizes GAAFR, it is necessary to amend the guide to recognize Statement 1 as an authoritative modification of GAAFR.¹

Recommendation

.03 The AICPA Committee on State and Local Government Accounting recommends that *Audits of State and Local Governmental Units* be amended throughout to refer to Statement 1 rather than GAAFR. Accordingly, financial statements presented in accordance with Statement 1 are in conformity with generally accepted accounting principles. The following paragraphs amplify that conclusion and explain its implementation with respect to the auditor's standard report.

.04 The following are the basic general purpose financial statements (GPFS) for a state or local governmental unit:

- a. Combined balance sheet: all fund types and account groups.
- b. Combined statement of revenues, expenditures, and changes in fund balances: all governmental fund types.
- c. Combined statement of revenues, expenditures, and changes in fund balances—budget and actual: general and special revenue fund types (and similar governmental fund types for which annual budgets have been legally adopted).
- d. Combined statement of revenues, expenses, and changes in retained earnings (or equity): all proprietary fund types.
- e. Combined statement of changes in financial position: all proprietary fund types.
- f. Notes to the financial statements.

¹ NCGA Statement 2, *Grant, Entitlement, and Shared Revenue Accounting and Reporting by State and Local Governments*, was also issued in March 1979 and is consistent with the AICPA industry audit guide.

(Trust fund operations may be reported in statements *b*, *d*, and *e* as appropriate, or separately.)

These financial statements, referred to collectively as the combined financial statements, are discussed and illustrated in Statement 1.

.05 Accounting and reporting of encumbrances should follow the approach recommended in Statement 1: Encumbrances outstanding at year-end should not be reported as expenditures or liabilities. The budgetary comparison statement (paragraph .04 *c*), however, should present comparisons of the legally adopted budget with actual data on the budgetary basis, which may include encumbrances or other differences from generally accepted accounting principles.

.06 The type of report that the auditor can issue depends on the financial statements that a governmental unit presents and on the scope of the examination. The combined financial statements listed in paragraph .04 are required for conformity with generally accepted accounting principles, and the auditor should report on those statements, as discussed in paragraph .07. In addition to the combined financial statements, a governmental unit may also issue combining, individual fund, and account group financial statements and supporting schedules, most likely for inclusion in a comprehensive annual financial report, as described in Statement 1 (pp. 19-20). The auditor's reports on such presentations are described in paragraphs .08 and .09. Paragraphs .10 through .13 describe the auditor's reports to be used if governmental units present other types of financial statements.

.07 If the auditor is engaged to examine the combined financial statements and the governmental unit presents only combined financial statements, the auditor should express an opinion on the financial position of the governmental unit, the results of its operations, and the changes in financial position of its proprietary fund types (see Appendix A). In these circumstances, because Statement 1 requires fund accounting (p. 2) and disclosures related to individual funds and account groups (pp. 5, 6, and 24), the scope of the auditor's examination of the combined financial statements ordi-

narily would include application of auditing procedures related to individual fund and account group financial data.

.08 If the auditor is engaged to examine the combined financial statements and the governmental unit also presents combining, individual fund, and account group financial statements and supporting schedules, the auditor should follow the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. Accordingly, the auditor's report should state whether the combining, individual fund, and account group financial statements and supporting schedules are stated fairly in all material respects in relation to the combined financial statements taken as a whole (see Appendix B), and the auditor should be satisfied that the combining, individual fund, and account group financial statements and supporting schedules are suitably titled. As explained in paragraph .07, the scope of the auditor's examination of the combined financial statements ordinarily would include application of auditing procedures to individual fund and account group data, and the auditor would be in a position to express such an opinion.

.09 If the auditor is engaged to examine both the combined financial statements and the combining, individual fund, and account group financial statements, his opinion should include both presentations. Ordinarily, in such circumstances the auditor will need to expand the auditing procedures that would otherwise be applied to the combining, individual fund, and account group financial statements. If supporting schedules accompany these financial statements, the auditor's report should state whether the information in the schedules is stated fairly in all material respects in relation to the financial statements taken as a whole (see Appendix C) or should disclaim an opinion on that information.

.10 If financial statements for fund types, funds, or account groups that should be included in the combined financial statements (such as the general fixed assets account group or an enterprise fund) are omitted, the auditor should consider the need to express a qualified opinion (see Appendix D) or an adverse opinion because of departure from generally accepted accounting

principles (see SAS No. 2, paragraphs 15 through 17). The auditor's report should include an explanatory paragraph that either describes the omitted fund types, funds, or account groups or, preferably, refers to a note that describes those matters.

.11 If all material individual funds and account groups are presented but the governmental unit does not present combined financial statements, the auditor should express an adverse opinion on the financial position of the governmental unit, the results of its operations, and the changes in financial position of its proprietary fund types. However, the auditor may also express an unqualified opinion on the individual fund and account group financial statements (see Appendix E).

.12 The auditor may be engaged to examine financial statements of only a specified enterprise fund and may express an opinion on whether those financial statements are prepared in conformity with generally accepted accounting principles (see Appendix F). A similar report would also be appropriate for a fund of another type (except for the general fund) or an account group. If the financial statements of only the general fund are presented, the auditor should follow the guidance in paragraph .13.

.13 If an auditor is engaged to examine the financial statements of the general fund or the financial statements of more than one fund or account group that are not intended to present fairly the financial position of the governmental unit taken as a whole, results of its operations, or changes in financial position of its proprietary fund types in conformity with generally accepted accounting principles, the auditor's report should be in the form indicated in Appendix F and should include a middle paragraph such as the following:

As described more fully in Note _____, the financial statements presented are only for the funds and account groups referred to above and are not intended to present fairly the financial position of the City of Example, Any State, at December 31, 19X2, or the results of its operations and the changes in the financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles.

.14 Combined financial statements of fund types and account groups may have a "total" column that aggregates the columnar statements by fund type and account group. If a total column is

shown, it should be captioned "Memorandum Only" because the total column on a combined financial statement is not comparable to a consolidation. A note to the financial statements should disclose the nature of the column and should explain that it does not present consolidated financial information.

.15 The provisions of this statement of position should be adopted for years ending on or after July 1, 1980. Early adoption is encouraged. If these recommendations are adopted early, conformity with principles in Statement 1 should be disclosed.

.16 Statement 1 (p. 26) states, "Adjustments resulting from a change to comply with these principles should be treated as adjustments of prior periods, and financial statements presented for the periods affected should be restated." Thus, accounting changes for governmental funds that are required to comply with Statement 1 principles—such as accrual of property taxes, a change in reporting encumbrances, or presentation of financial statements of a different reporting entity (such as a fund not previously included in the financial statements)—should be reported by restatement of the financial statements for all prior periods presented. The auditor should refer to SAS no. 1, section 546, for guidance on reporting on a change in accounting principle. Statement 1 does not change proprietary fund accounting principles.

APPENDIX A

.17 Auditor's Report: Unqualified Opinion on Combined Financial Statements

We have examined the combined financial statements of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. 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.

In our opinion, the combined financial statements referred to above present fairly the financial position of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

APPENDIX B

.18 Auditor's Report: Unqualified Opinion on Combined Financial Statements Presented With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules

We have examined the combined financial statements of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. 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.

In our opinion, the combined financial statements referred to above present fairly the financial position of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the combined financial statements taken as a whole. The combining, individual fund, and account group financial statements and schedules listed in the table of contents are presented for purposes of additional analysis and are not a required part of the combined financial statements of the City of Example, Any State. The information has been subjected to the auditing procedures applied in the examination of the combined financial statements and, in our opinion, is fairly stated in all material respects in relation to the combined financial statements taken as a whole.

APPENDIX C

.19 Auditor's Report: Unqualified Opinion on Combined Financial Statements and Combining, Individual Fund, and Account Group Financial Statements Presented With Supporting Schedules

We have examined the combined financial statements of the City of Example, Any State, and the combining, individual fund, and account group financial statements of the city as of and for the year ended December 31, 19X2, as listed in the table of contents. 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.

In our opinion, the combined financial statements referred to above present fairly the financial position of the City of Example, Any State, at

December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Also, in our opinion, the combining, individual fund, and account group financial statements referred to above present fairly the financial position of the individual funds and account groups of the City of Example, Any State, at December 31, 19X2, and the results of operations of such funds and the changes in financial position of individual proprietary funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the combined financial statements taken as a whole and on the combining, individual fund, and account group financial statements. The accompanying financial information listed as supporting schedules in the table of contents is presented for purposes of additional analysis and is not a required part of the combined financial statements of the City of Example, Any State. The information has been subjected to the auditing procedures applied in the examination of the combined, combining, individual fund, and account group financial statements and, in our opinion, is fairly stated in all material respects in relation to the combined financial statements taken as a whole.

APPENDIX D

.20 Auditor's Report: Qualified Opinion on Combined Financial Statements (One or More Fund Types, Funds, or Account Group Financial Statements Omitted)

We have examined the combined financial statements of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. 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.

As described more fully in Note —, the combined financial statements referred to above do not include financial statements of the [identify fund types, funds, or account groups omitted], which should be included to conform with generally accepted accounting principles.

In our opinion, except that the omission of the financial statements described above results in an incomplete presentation, as explained in the preceding paragraph, the combined financial statements referred to above present fairly the financial position of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then

ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

APPENDIX E

.21 Auditor's Report: Adverse Opinion (Omission of Combined Financial Statements) With an Unqualified Opinion on the Individual Fund and Account Group Financial Statements

We have examined the financial statements of the individual funds and account groups of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The city has not prepared combined financial statements that show the financial position of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, as required by generally accepted accounting principles. Thus, in our opinion, the financial statements listed in the table of contents do not present fairly the financial position of the City of Example, Any State, at December 31, 19X2, or the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles.

In our opinion, however, the financial statements listed in the table of contents present fairly the financial position of the individual funds and account groups of the City of Example, Any State, at December 31, 19X2, and the results of operations of such funds and the changes in financial position of individual proprietary funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

APPENDIX F

.22 Auditor's Report: Unqualified Opinion on an Enterprise Fund's Financial Statements

We have examined the financial statements of the [identify enterprise fund] of the City of Example, Any State, as of and for the year ended December 31, 19X2, as listed in the table of contents. 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.

In our opinion, the financial statements referred to above present fairly the financial position of the [identify enterprise fund] of the City of Example, Any State, at December 31, 19X2, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

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The division gratefully acknowledges the contribution made to the development of this statement of position by past members of the AICPA Committee on State and Local Government Accounting (1978-1979):

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Section 10,320**Statement of Position 80-3
Accounting for Real Estate Acquisition,
Development, and Construction Costs***

December 22, 1980

[Proposal to the Financial Accounting Standards Board]**NOTE**

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

Introduction

.01 Recent trends in real estate development activities have dramatically increased the size of enterprises engaged in real estate development, the cost of individual projects, and the time required to complete the development of individual projects. Those trends have focused attention on the need for guidance in accounting for costs associated with real estate acquisition, development, and construction. The accounting standards division of the American Institute of Certified Public Accountants has prepared this statement of position in response to that need.

Scope of the Statement

.02 Except as indicated in paragraph .03, the recommendations in this statement apply to accounting for real estate acquisition, development, and construction costs in financial statements that are intended to present financial position, results of operations, or

* See also FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982

changes in financial position in conformity with generally accepted accounting principles, regardless of the nature of the entity involved. The division believes that, in providing guidance, it is desirable to reduce, to the extent practicable, alternative practices in accounting for costs of real estate acquisition, development, and construction.

.03 This statement does not apply to

- a. Real estate developed by an enterprise for use in its own operations (excluding sale or rental). In this context, "real estate developed by an enterprise for use in its own operation" includes real estate developed by a member of a consolidated group for use in the operations of another member of the group (for example, a manufacturing facility developed by a subsidiary for use in its parent's operations) when the property is reported in the group's consolidated financial statements. However, such property is not "real estate developed for use in the enterprise's operations" when reported in the separate financial statements of the entity that developed it.
- b. Retail lots sold on a volume basis with down payments that are less than those required to evaluate the collectibility of casual real estate sales. The AICPA industry accounting guide, *Accounting for Retail Land Sales**, applies to accounting for lots sold on that basis.
- c. Costs and operations covered by the AICPA statement of position [section 10,180]**, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects*.

.04 Because of the nature of the issues discussed in this statement, and because of the variety of enterprises whose transactions are covered by this statement, the division emphasizes that the provisions of this statement, like the provisions of all statements on accounting principles, need not be applied to items that would have an immaterial effect on an enterprise's financial position or results of operations; also, methods other than those recommended may be used if their use yields results not materially different from the results of applying the recommended methods.

Definitions

.05 For purposes of this statement, the following terms are defined:

* See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982, and FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.

** See also FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate*, October 1982.

- a. *Common costs.* Costs that relate to two or more units within a real estate project and thus require allocation to determine the cost of project subdivisions. For example, land cost is usually common to the entire project and must be allocated to phases, tracts, releases, and, ultimately, individual units to determine the cost of sales or the cost of individual units of investment property. Other common costs may relate only to a phase, a tract, or a release and would be allocated only to the parcels to which they relate.
- b. *Fair value.* The amount in cash or cash equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. The fair value of a parcel is affected by its physical characteristics, its probable ultimate use, and the time required for the buyer to make use of the property, considering access, development plans, zoning restrictions, and market absorption factors. *Relative fair value* is the fair value of each parcel in a real estate project in relation to the fair value of the other parcels in the project. *Relative fair value before construction* is the fair value of each land parcel in a real estate project in relation to the fair value of the other parcels in the project, exclusive of value added by on-site development and construction activities.
- c. *Incidental operations.* Minor revenue-producing activities engaged in during the holding or development period to reduce the cost of developing the property for its intended use, as distinguished from activities designed to generate a profit or a return from the use of the property.
- d. *Incremental revenues and costs of incidental operations.* Revenues that would not be produced, or costs that would not be incurred, except in relation to the conduct of incidental operations. Costs that are not incremental are interest, taxes, insurance, security, and similar costs that would be incurred during the development of a real estate project regardless of whether incidental operations were conducted.

Nature of Real Estate Acquisition, Development, and Construction Activities

.06 Real estate acquisition, development, and construction activities occur in four stages: (a) predevelopment, (b) development, (c) construction, and (d) sales or rental operations. Distinguishing

between different stages, or distinguishing the beginning and end of some stages, may often be difficult because similar costs may be incurred in different stages.

.07 During the predevelopment stage, the purchaser investigates the property, negotiates for its acquisition, and finally enters into a formal contract to acquire the property. In addition to the agreed consideration, the purchaser incurs costs for related legal, recording, and title services. Costs also may be incurred for such activities as appraisals, market feasibility studies, architectural and engineering services, soil tests, and zoning changes. Some of those costs may be incurred before there is a formal commitment to acquire the property.

.08 Real estate builders and developers may acquire property well in advance of the beginning of construction and hold the property for an extended period while preparing development and building plans and obtaining zoning changes and other required permits. During that period, costs are incurred for those activities and for such items as interest and property taxes.

.09 On-site and off-site improvements, such as roads, sewers, utilities, grading, and site clearance, are made before the construction stage. Zoning approvals and building permits may require the developer to set aside land for community facilities (such as schools, parks, and roads) to be donated to local authorities or governmental units. Developers may be required to contribute funds to governmental units to help finance the construction of facilities, such as sewer plants and schools, to serve the property.

.10 Real estate developers may receive revenue from, and incur costs for, incidental operations relating to real estate, such as the operation of temporary parking lot facilities or the leasing of undeveloped land for grazing or farming.

.11 Real estate projects may include amenities, such as golf courses, tennis courts, indoor recreational facilities, parking facilities, and utility plants. Some amenities are sold to tenants' or homeowners' associations; others are intended to be self-supporting enterprises. Some or all of the costs of other amenities are expected to be recovered from lease or sale.

.12 Differentiating between costs to be charged to expense and costs to be capitalized and associating capitalized costs with partic-

ular assets pose complex problems in accounting for real estate projects. Real estate projects generally require several accounting periods to complete. In addition, large real estate projects usually involve multiple purchases and sales that require complex cost accumulation and allocation techniques. Development and construction plans and costs and revenues are affected by such factors as market conditions, inflation, interest rates, zoning restrictions, terrain, and location. For example, a residence next to a golf course or an office near the top of an office tower usually generates more revenue than a similar unit otherwise situated.

Present Accounting Practices

Cost Capitalization

.13 Except for the general practice of capitalizing direct acquisition, development, and construction costs, cost capitalization practices vary widely. Some entities capitalize property-related costs incurred before the acquisition of the property and include them in the cost of the property when it is acquired. Some entities capitalize as property costs expenditures during the development and construction phases for interest, taxes, insurance, and indirect project costs (indirect costs related to project development and construction). Others capitalize only some or none of those costs. An entity may have different capitalization practices for different projects or for different components of a particular project.

.14 Accounting for revenues and expenses of amenities and incidental operations also varies. Some enterprises account for such revenues and expenses as decreases or increases in capitalized project costs, and others include them in current operating results.

Allocation of Capitalized Costs

.15 Real estate developers generally use one or more, including a combination, of the following methods to allocate capitalized costs: area, value, and specific identification. Under area methods, common costs are allocated to individual units based on the number of units or size, such as acreage or square footage. Under value methods, costs are allocated to individual units based on the relative value of the individual units. Under specific identification methods, costs identified with a specific property are assigned to that property. Common costs associated with the entire development, such as access roads, utility trunk lines, and amenities, usually are allocated by area and value methods.

The Division's Conclusions

.16 As a general rule, costs clearly associated with the acquisition, development, and construction of a real estate project should be capitalized. The division believes, however, that the recommendations in this statement should be applied to the following: (a) preacquisition costs, (b) interest, taxes, and insurance, (c) indirect project costs, (d) amenities, (e) incidental operations, (f) allocation of capitalized costs to components of a real estate project, (g) revisions of estimates, (h) costs in excess of estimated net realizable value, (i) abandonments and changes in use, and (j) cost of sales.

Preacquisition Costs

.17 Payments to obtain an option should be capitalized as incurred. Other costs related to a property that are incurred before the enterprise acquires the property, or before the enterprise obtains an option to acquire it, should be deferred, provided all three of the following conditions are met:

- a The costs are directly identifiable with the specific property.
- b The costs would be capitalized if the property were already acquired.
- c Acquisition of the property or of an option to acquire the property is probable.¹ For this condition to be met, the prospective purchaser must be actively seeking to acquire the property and must have the ability to finance or obtain financing for the acquisition under circumstances in which there is no evidence indicating that the property is not available for sale.

If any one of these three conditions is not met, costs incurred before a property is acquired should be charged to expense as incurred.

.18 Option costs and the accumulated amount of deferred preacquisition costs (a) should be capitalized as project costs on acquisition of the property or (b) to the extent not recoverable by sale of the options, plans, and so forth, should be charged to expense when it is probable that the property will not be acquired. The amount of option costs and deferred preacquisition costs should be disclosed in the financial statements.

¹Probable is defined for accounting purposes in Statement of Financial Accounting Standards 5 as "likely to occur" and is used in the same sense in this statement

Interest, Taxes, and Insurance

.19 Statement of Financial Accounting Standards 34, *Capitalization of Interest Cost*, prescribes the accounting for interest cost. Costs incurred on real estate for property taxes, insurance, and similar items should be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress. Costs incurred for such items after the property is substantially complete and ready for its intended use should be charged to expense as incurred.

Indirect Project Costs

.20 *Indirect project costs* are indirect costs incurred after the acquisition of the property, such as construction administration, legal fees, and various office costs (cost accounting, design, and other departments providing services to projects), that clearly relate to projects under development or construction. Some indirect project costs clearly relate to a specific project, such as costs associated with a field office at a project site and the administrative personnel that staff the office, and they should be capitalized as a cost of that project. Other indirect project costs may relate to several projects and should be capitalized and allocated to the projects to which the costs relate in a rational manner based on the nature of activity that gave rise to the costs. To illustrate, 60 percent of a construction administration department's time is spent managing internal projects under current development, 35 percent is spent managing projects for others for a fee, and 5 percent is spent administering the maintenance of operating properties; 60 percent of the costs should be capitalized and allocated to the project, and 40 percent should be charged to expense as incurred.

.21 Indirect costs that do not clearly relate to projects under development or construction and all general and administrative costs should be charged to expense as incurred.² General and administrative costs include such costs as entity management salaries, general accounting, corporate office expense, general legal services, and similar costs of the type generally incurred by all enterprises for the conduct of business.

² Costs to sell and rent real estate projects should be accounted for in accordance with AICPA Statement of Position 78-3 [section 10,180], *Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects*. [See also FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.]

Amenities

.22 Accounting for costs of amenities, such as golf courses, utility plants, clubhouses, swimming pools, and tennis courts, should be based on management's plans for the amenities in accordance with the following:

- a. If an amenity is to be sold or transferred in connection with the sale of individual units, costs (including expected future operating costs to be borne by the developer until they are assumed by buyers of units in a project) in excess of anticipated proceeds should be allocated as common costs since the amenity is clearly associated with the development and sale of the project.
- b. If an amenity is to be sold separately or retained by the developer, capitalizable cost of the amenity in excess of its estimated fair value, as of the expected date of its substantial physical completion, should be allocated as common costs.³ For the purpose of determining the amount to be capitalized as common costs, the amount of cost allocated to the amenity should not be revised after it is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value as of the date of substantial physical completion, less any accumulated depreciation, gives rise to a gain or loss that should be included in net income in the period in which the sale occurs.

As indicated in paragraph .26 of this statement, common costs should be allocated on the basis of relative fair value (before construction) of each land parcel benefitted. In allocating costs of amenities as common costs, land parcels benefitted should be limited to those for which development can reasonably be expected.

.23 Before an amenity is substantially completed and available for use, operating results of the amenity should be included as a reduction of, or addition to, common costs. When an amenity to be sold separately or held for investment is substantially completed and available for use, current operating income and expenses of the amenity should be included in current operating results, since the operations of the amenity no longer clearly relate to the develop-

³The accounting for costs of amenities to be sold separately or retained by the developer recommended in this statement differs from the accounting for costs of such amenities under the AICPA industry accounting guide, *Accounting for Retail Land Sales*, because of differences in circumstances. This statement does not apply to transactions to which that guide applies. [See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982, and FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.]

ment and sale of the project as a whole but, rather, relate to the objective of making a profit on operations or sale of the amenity itself or of using the amenity as a sales promotional tool.

.24 The following assumed data are used to illustrate the application of the recommended accounting for the costs of amenities:

- a. A single family residential project is to include a recreation center, consisting of a swimming pool and tennis courts, with an estimated cost of \$250,000.
- b. The center is to be transferred to a homeowners' association in connection with the sale of the units in the project.
- c. Each purchaser of a unit will be obligated to pay a monthly assessment fee.
- d. The developer agrees to pay net operating costs before the expected date of transfer and the monthly assessment fees for all unsold units. Such support is estimated to cost \$50,000.

Based on these assumptions, the total estimated cost of \$300,000 (the \$250,000 cost of the center plus \$50,000 in support costs to be paid by the developer) should be allocated as common costs based on the relative fair value of each lot benefitted. The accounting would differ, however, if the assumptions were modified as follows:

- a. The center is to be retained by the developer.
- b. Net operating costs are estimated to be \$30,000 before substantial physical completion and \$20,000 after substantial physical completion.
- c. The fair value of the center at the date of substantial physical completion is estimated to be \$200,000.

Under the modified assumptions, \$80,000, the amount by which the costs of the center plus the estimated net operating costs before substantial completion (\$250,000 plus \$30,000) exceed the estimated fair value at the date of substantial physical completion (\$200,000), should be allocated as common costs. Actual operating losses incurred after substantial physical completion should be included in current operating results.

Incidental Operations

.25 An excess of incremental revenue over the incremental costs of incidental operations, such as the operation of temporary

parking lot facilities or the leasing of undeveloped land for grazing or farming, should be accounted for as a reduction of capitalized project costs. An excess of incremental costs over incremental revenue should be charged to expense as incurred, since it did not achieve the objective of reducing the cost of developing the property for its intended use.

Allocation of Capitalized Costs to the Components of a Real Estate Project

.26 To the extent that this is practicable, the costs of acquisition, development, and construction of real estate projects should be capitalized and assigned to individual components of the project on the basis of specific identification. Land cost and all other common costs should be allocated on the basis of the relative fair value (before construction) at the date of allocation to each land parcel benefited.⁴ The division believes that allocation on the basis of relative fair value is consistent with the generally accepted principle for allocating joint costs to separable outputs and assigns joint costs to individual parcels, phases, and units on the basis of their potential revenue contributions.

.27 A land parcel may be considered to be an individual lot or a "phase," defined for this purpose as a parcel on which units are to be constructed concurrently. It may be necessary to accumulate costs in one or more cost centers before final allocation if some costs apply to different portions of a project, for example, if some costs apply only to certain components of a project and other costs apply to other components or to the entire project.

.28 Construction costs should be assigned to the individual units in a phase on the basis of specific identification, if practicable. Otherwise, construction costs applicable to the phase should be allocated to individual units in the phase in a reasonable manner that achieves results comparable to allocation on the basis of the relative sales value of the individual units to the sales value of the total units in the phase.

⁴ The AICPA industry accounting guide, *Accounting for Retail Land Sales*, permits the use of other methods of allocating common costs (for example, the area method) that fairly match costs with related revenues. This statement does not apply to transactions to which that guide applies. [See also FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982, and FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, October 1982.]

.29 For the purpose of illustrating the general principles, a developer is assumed to have under development a single-family residential subdivision for which assigning costs to individual units by specific identification is impracticable. The smallest practicable unit for that purpose is a group of units to be constructed as a separate phase and sold individually. Based on those assumptions, the cost allocations might be as follows:

- a. On-site and off-site costs specifically identified with the units in the phase would be allocated to the phase.
- b. Common costs of the entire project (or a parcel) of which the phase is a part would be allocated to the phase on the basis of the relative fair value of the land in the phase (before construction) to that of the project (or parcel).
- c. Costs allocated to the phase would be allocated to an individual unit on the basis of the relative sales value of the unit to that of all units in the phase. If a phase includes both units to be sold and units to be held for investment, the final allocation would be made to the investment units on the basis of the relative fair value of the investment units to the total of the sales value of the units to be sold and the fair value of the investment units.

This illustration applies only to costs for which assignment to individual units on the basis of specific identification is not practicable. To the extent that it is practicable, all costs should be assigned to individual units on the basis of specific identification.

Revisions of Estimates

.30 Estimates and cost allocations should be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Costs should be revised and reallocated as necessary for material changes on the basis of current estimates. Changes in estimates should be accounted for in accordance with paragraph 31 of APB Opinion 20, *Accounting Changes*, which states

The effect of a change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in an estimate should not be accounted for by restating

➤→ *The next page is 18,851-3.* ←➤

amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

Most revisions of estimates relating to real estate cost allocations affect both the period of the change and future periods, and their effects should therefore be accounted for prospectively in the period of the change and future periods. For example, an increase in the estimate of the common costs of a project should be allocated to current and future periods even though the allocation results in lower profit margins on current and future sales than on prior sales from the project. However, increases in costs without comparable increases in market value can raise questions about whether the estimated total cost of property not yet sold exceeds its net realizable value.⁵

.31 When an enterprise records sales of real estate and records its cost of sales accruals for estimated costs to be incurred (which may include a portion of estimated common costs allocable to the property sold—see paragraph .35 of this statement), changes in estimates of those costs should be recorded in cost of sales in the period in which the differences become known, since they are unrelated to future operating results.⁶ To illustrate, the following circumstances are assumed: (a) sales of property were recorded in full in prior periods and did not require any deferral of revenue for future performance and (b) estimated costs of \$200,000 have been accrued relating to the sales revenue previously recorded. If current estimates of such costs are \$250,000, an additional \$50,000 should be accrued and charged to cost of sales in the current period.

⁵ In accounting for sales of real estate in circumstances in which the seller has an obligation of future performance to complete improvements and amenities of a project, the seller may be required to record a portion of the sales price as deferred revenue based on the ratio of the estimated cost of the future performance to total cost. (See the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate* and FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.) Revisions of estimated costs to complete project improvements and amenities may relate to previously recorded deferred revenue. In those cases, the relationship of the two elements comprising the deferred revenue—costs and profit—should be recalculated to determine the amount of the deferred revenue to be recognized as the costs are incurred. However, if the revised estimated cost of future performance exceeds the remaining applicable deferred revenue, the excess should not be deferred but, rather, should be charged to income immediately.

⁶ If, in accordance with paragraphs 47 through 50 of the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*, all or a portion of the revenue for a sales transaction is deferred because the seller has an obligation for future performance, the costs related to the revenue should be recognized when the sales revenue is recognized. [See also FASB Statement No. 66, *Accounting for Sales of Real Estate Projects*, October 1982.]

Cost in Excess of Estimated Net Realizable Value

.32 Capitalization of costs associated with the development and construction of a property should not cease when present accounting principles require recognition of a lower value for the asset than acquisition cost.⁷ When the capitalized cost of real estate held for sale or for development and sale exceeds its estimated net realizable value, an allowance should be provided to reduce the carrying amount to estimated net realizable value, determined on the basis of an evaluation of individual projects. An individual project, for this purpose, consists of components that are relatively homogeneous, integral parts of a whole (for example, individual houses in a residen-

⁷ For real estate held for sale or development and sale, the lower value to be recognized is net realizable value (NRV). NRV is the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining selling price), holding, and disposal.

tial tract, individual units in a condominium complex, and individual lots in a lot subdivision). Therefore, a multiphase development consisting of a tract of single-family houses, a condominium complex, and a lot subdivision generally would be evaluated as three separate projects.

Abandonments and Changes in Use

.33 Real estate, including rights to real estate, may be abandoned, for example, by allowing a mortgage to be foreclosed or by allowing a purchase option to lapse. Capitalized costs, including allocated common costs, of real estate abandoned should be written off as current expenses or, if appropriate, to allowances previously established for that purpose and should not be allocated to other components of the project or to other projects, even if other components or other projects are capable of absorbing the losses. Donations of land to municipalities or other governmental agencies for uses that will benefit the project are not abandonments. The cost of the land donated should be allocated as a common cost of the project.

.34 Changes in the use of real estate comprising a project or a portion of a project may arise after significant development or construction costs have been incurred. In such circumstances, development and construction costs incurred before the change should be written off, except as follows:

- a. If the change is made pursuant to a formal plan for a project that is expected to produce a higher economic yield, the write-off may be limited to the amount by which the capitalized costs incurred and to be incurred exceed the estimated value of the revised project at the date of substantial physical completion.
- b. In the absence of a formal plan for a project that is expected to produce a higher economic yield, the write-off may be limited to the amount by which total capitalized costs exceed the estimated net realizable value of the property, determined on the assumption that it will be sold in its present state.

To illustrate, the total capitalized costs of a golf course are assumed to be \$1 million, including development and construction costs of \$700,000 and land costs of \$300,000. If, pursuant to a formal plan, the golf course is to be torn up in order to build single-family residences for sale, and such use would recover the capitalized costs

of the golf course as well as the construction and development costs of the new project, the \$1 million may be included in the cost of the new project. If, on the other hand, golf course operations are terminated by reason of continuing operating losses without a formal plan for a project expected to produce a higher economic yield, the \$700,000 of development and construction costs should be written off to the extent that the total unrecovered costs of \$1 million exceed the estimated net realizable value of the property in its present state.

Cost of Sales

.35 Costs applicable to real estate should be charged to cost of sales when the related sales revenue is recorded in operating results.⁸ Such costs include the allocated portion of costs incurred plus accruals (including revisions—see paragraph .31) for estimated costs to be incurred for the real estate sold.

Transition

.36 The accounting standards division recommends the application of the provisions of this statement prospectively for fiscal years, and interim periods in those fiscal years, beginning after December 24, 1980. Earlier application is encouraged for fiscal years beginning before December 25, 1980, for which financial statements have not been issued. Costs capitalized or deferred in accordance with generally accepted accounting principles in years before the fiscal year for which the provisions of this statement are first applied should not be written off, even though such costs do not qualify for capitalization or deferral according to the conclusions in this statement. Such capitalized costs should be reallocated to components of real estate projects in accordance with the conclusions in this statement unless it is not practicable to do so. Changes in estimates and reallocations made to conform with the conclusions in this statement should be accounted for as revisions of estimates, as discussed in paragraphs .30 and .31 of this statement. Costs charged to expense in years before the fiscal year for which the provisions of this statement are first applied should not be capitalized or deferred to conform to the conclusions in this statement.

⁸For a discussion of circumstances under which recognition of revenue is deferred because of the seller's obligation for future performance, see note 6

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The division gratefully acknowledges the contribution made to the development of this statement of position by past members of the AICPA Committee on Real Estate Accounting (1978–1979):

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Section 10,330***Statement of Position 81-1
Accounting for Performance of
Construction-Type and Certain
Production-Type Contracts***

July 15, 1981

[Proposal to Financial Accounting Standards Board]**NOTE**

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

Introduction

.01 This statement of position provides guidance on the application of generally accepted accounting principles in accounting for the performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or for the provision of related services. Changes in the business environment have increased significantly the variety and uses of those types of contracts and the types of business enterprises that use them. In the present business environment, diverse types of contracts, ranging from relatively simple to highly complex and from relatively short- to long-term, are widely used in many industries for construction, production, or provision of a broad range of goods and services. However, existing principles related to accounting for contracts were written in terms of long-term

construction-type contracts, and they are not stated in sufficient detail for the scope of activities to which they presently are applied. Those activities range far beyond the traditional construction-type activity (the design and physical construction of facilities such as buildings, roads, dams, and bridges) to include, for example, the development and production of military and commercial aircraft, weapons delivery systems, space exploration hardware, and computer software. The accounting standards division believes that guidance is now needed in this area of accounting.

The Basic Accounting Issue

.02 The determination of the point or points at which revenue should be recognized as earned and costs should be recognized as expenses is a major accounting issue common to all business enterprises engaged in the performance of contracts of the types covered by this statement. Accounting for such contracts is essentially a process of measuring the results of relatively long-term events and allocating those results to relatively short-term accounting periods. This involves considerable use of estimates in determining revenues, costs, and profits and in assigning the amounts to accounting periods. The process is complicated by the need to evaluate continually the uncertainties inherent in the performance of contracts and by the need to rely on estimates of revenues, costs, and the extent of progress toward completion.

Present Accounting Requirements and Practices

.03 The pervasive principle of realization and its exceptions and modifications are central factors underlying accounting for contracts. APB Statement 4 states:

Revenue is generally recognized when both of the following conditions are met: (1) the earnings process is complete or virtually complete, and (2) an exchange has taken place. [Paragraph 150]

Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results. [Paragraph 152]

The exception to the usual revenue realization rule for long-term construction-type contracts, for example, is justified in part because

strict adherence to realization at the time of sale would produce results that are considered to be unreasonable. The judgment of the profession is that revenue should be recognized in this situation as construction progresses. [Paragraph 174]

.04 Accounting Research Bulletin no. 45 (ARB 45), *Long-Term Construction-Type Contracts*, issued by the AICPA Committee on Accounting Procedure in 1955, describes the two generally accepted methods of accounting for long-term construction-type contracts for financial reporting purposes:

- *The percentage-of-completion method* recognizes income as work on a contract progresses; recognition of revenues and profits generally is related to costs incurred in providing the services required under the contract.
- *The completed-contract method* recognizes income only when the contract is completed, or substantially so, and all costs and related revenues are reported as deferred items in the balance sheet until that time.

The AICPA Industry Audit Guide, *Audits of Government Contractors*, describes units-of-delivery as a modification of the percentage-of-completion method of accounting for contracts.

- *The units-of-delivery method* recognizes as revenue the contract price of units of a basic production product delivered during a period and as the cost of earned revenue the costs allocable to the delivered units; costs allocable to undelivered units are reported in the balance sheet as inventory or work in progress. The method is used in circumstances in which an entity produces units of a basic product under production-type contracts in a continuous or sequential production process to buyers' specifications.

The use of either of the two generally accepted methods of accounting involves, to a greater or lesser extent, three key areas of estimates and uncertainties: (a) the extent of progress toward completion, (b) contract revenues, and (c) contract costs. Although the ultimate amount of contract revenue is often subject to numerous uncertainties, the accounting literature has given little attention to the difficulties of estimating contract revenue.

.05 ARB 45, paragraph 15, describes the circumstances in which each method is preferable as follows:

The committee believes that in general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable.

Both of the two generally accepted methods are widely used in practice. However, the two methods are frequently applied differently in similar circumstances. The division believes that the two methods should be used in specified circumstances and should not be used as acceptable alternatives for the same circumstances. Accordingly, identifying the circumstances in which either of the methods is preferable and the accounting that should be followed in the application of those methods are among the primary objectives of this statement of position. This statement provides guidance on the application of ARB 45 and does not amend that bulletin.

.06 In practice, methods are sometimes found that allocate contract costs and revenues to accounting periods on (a) the basis of cash receipts and payments or (b) the basis of contract billings and costs incurred. Those practices are not generally accepted methods of accounting for financial reporting purposes. However, those methods are appropriate for other purposes, such as the measurement of income for income tax purposes, for which the timing of cash transactions is a controlling factor. Recording the amounts billed or billable on a contract during a period as contract revenue of the period, and the costs incurred on the contract as expenses of the period, is not acceptable for financial reporting purposes because the amounts billed or billable on a contract during a period are determined by contract terms and do not necessarily measure performance on the contract. Only by coincidence might those unacceptable methods produce results that approximate the results of the generally accepted method of accounting for contracts that are appropriate in the circumstances.

Other Pronouncements and Regulations Affecting Contract Accounting

.07 Accounting Research Bulletin no. 43, chapter 11, "Government Contracts," prescribes generally accepted principles in three areas of accounting for government contracts. Section A of that chapter deals with accounting problems arising under cost-plus-

fixed-fee contracts. Section B deals with certain aspects of the accounting for government contracts and subcontracts that are subject to renegotiation. Section C deals with problems involved in accounting for certain terminated war and defense contracts. Those pronouncements govern accounting for contracts in the areas indicated.

.08 The pricing and costing of federal government contracts are governed by cost principles contained in procurement regulations such as the Federal Procurement Regulation (FPR) and the Defense Acquisition Regulation (DAR). Also, most major government contractors are subject to cost accounting standards issued by the Cost Accounting Standards Board (CASB). CASB standards apply to the cost accounting procedures that government contractors use to allocate costs to contracts; CASB standards are not intended for financial reporting.

.09 Accounting for contracts for income tax purposes is prescribed by the Internal Revenue Code and the related rules and regulations. The methods of accounting for contracts under those requirements are not limited to the two generally accepted methods for financial reporting. For numerous historical and practical reasons, tax accounting rules and regulations differ from generally accepted accounting principles. Numerous nonaccounting considerations are appropriate in determining income tax accounting. This statement deals exclusively with the application of generally accepted accounting principles to accounting for contracts in financial reporting. It does not apply to income tax accounting and is not intended to influence income tax accounting.

Need for Guidance

.10 Because of the complexities and uncertainties in accounting for contracts, the increased use of diverse types of contracts for the construction of facilities, the production of goods, or the provision of related services, and present conditions and practices in industries in which contracts are performed for those purposes, additional guidance on the application of generally accepted accounting principles is needed. This statement of position provides that guidance. Appendix A contains a schematic chart showing the organization of the statement.

Scope of Statement of Position

.11 This statement of position applies to accounting for performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or the provision of related services that are reported in financial statements prepared in conformity with generally accepted accounting principles.¹ Existing authoritative accounting literature uses the terms "long-term" and "construction-type" in identifying the types of contracts that are the primary focus of interest. The term "long-term" is not used in this statement of position as an identifying characteristic because other characteristics are considered more relevant for identifying the types of contracts covered. However, accounting for contracts by an entity that primarily has relatively short-term contracts is recommended in paragraph .31 of this statement. The scope of the statement is not limited to construction-type contracts.

Contracts Covered

.12 Contracts covered by this statement of position are binding agreements between buyers and sellers in which the seller agrees, for compensation, to perform a service to the buyer's specifications.² Contracts consist of legally enforceable agreements in any form and include amendments, revisions, and extensions of such agreements. Performance will often extend over long periods, and the seller's right to receive payment depends on his performance in accordance with the agreement. The service may consist of designing, engineering, fabricating, constructing, or manufacturing related to the construction or the production of tangible assets. Contracts such as leases and real estate agreements, for which authoritative accounting literature provides special methods of accounting, are not covered by this statement.

.13 Contracts covered by this statement include, but are not limited to, the following:

¹This statement is not intended to apply to "service transactions" as defined in the FASB's October 23, 1978 Invitation to Comment, *Accounting for Certain Service Transactions*. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement, and construction management (see paragraph .13 for examples).

²Specifications imposed on the buyer by a third party (for example, a government or regulatory agency or a financial institution) or by conditions in the marketplace are deemed to be "buyer's specifications."

- Contracts in the construction industry, such as those of general building, heavy earth moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical, or paving).
- Contracts to design and build ships and transport vessels.
- Contracts to design, develop, manufacture, or modify complex aerospace or electronic equipment to a buyer's specification or to provide services related to the performance of such contracts.
- Contracts for construction consulting service, such as under agency contracts or construction management agreements.
- Contracts for services performed by architects, engineers, or architectural or engineering design firms.

.14 Contracts not covered by this statement include, but are not limited to, the following:

- Sales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels if such sales are normally recognized as revenue in accordance with the realization principle for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.
- Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period of time.
- Contracts included in a program and accounted for under the program method of accounting. For accounting purposes, a program consists of a specified number of units of a basic product expected to be produced over a long period in a continuing production effort under a series of existing and anticipated contracts.³
- Service contracts of health clubs, correspondence schools, and similar consumer-oriented organizations that provide their services to their clients over an extended period.
- Magazine subscriptions.

³The division is preparing a separate statement of position on program accounting, which will provide guidance on the circumstances in which existing and anticipated production-type contracts may be combined for the purpose of accumulating and allocating production costs

- Contracts of nonprofit organizations to provide benefits to their members over a period of time in return for membership dues.

.15 Contracts covered by this statement may be classified into four broad types based on methods of pricing: (a) fixed-price or lump-sum contracts, (b) cost-type (including cost-plus) contracts, (c) time-and-material contracts, and (d) unit-price contracts. A fixed-price contract is an agreement to perform all acts under the contract for a stated price. A cost-type contract is an agreement to perform under a contract for a price determined on the basis of a defined relationship to the costs to be incurred, for example, the costs of all acts required plus a fee, which may be a fixed amount or a fixed percentage of the costs incurred. A time-and-material contract is an agreement to perform all acts required under the contract for a price based on fixed hourly rates for some measure of the labor hours required (for example, direct labor hours) and the cost of materials. A unit-price contract is an agreement to perform all acts required under the contract for a specified price for each unit of output. Each of the various types of contracts may have incentive, penalty, or other provisions that modify their basic pricing terms. The pricing features of the various types are discussed in greater detail in Appendix B.

Definition of a Contractor

.16 The term “contractor” as used in this statement refers to a person or entity that enters into a contract to construct facilities, produce goods, or render services to the specifications of a buyer either as a general or prime contractor, as a subcontractor to a general contractor, or as a construction manager.

Definition of a Profit Center

.17 For the purpose of this statement, a “profit center” is the unit for the accumulation of revenues and costs and the measurement of income. For business enterprises engaged in the performance of contracts, the profit center for accounting purposes is usually a single contract; but under some specified circumstances it may be a combination of two or more contracts, a segment of a contract or of a group of combined contracts. This statement of position provides guidance on the selection of the appropriate profit center. The accounting recommendations, usually stated in terms of a single contract, also apply to alternative profit centers in circumstances in which alternative centers are appropriate.

Application and Effect on Existing Audit Guides and SOPs

.18 This statement of position presents the division's recommendations on accounting for contracts (as specified in paragraphs .11 to .17) in all industries. The recommendations in this statement need not be applied to immaterial items. Two existing AICPA Industry Audit Guides, *Audits of Construction Contractors* and *Audits of Government Contractors*, provide additional guidance on the application of generally accepted accounting principles to the construction industry and to government contracts, respectively. The recommendations in this statement take precedence in those areas. *Audits of Construction Contractors* is being revised concurrently with this statement to conform to its provisions.

.19 The guidance on contract accounting and financial reporting in *Audits of Government Contractors* is essentially consistent with the recommendations in this statement except that this statement recommends the cumulative catch-up method for accounting for changes in estimates under the percentage-of-completion method of accounting, whereas either the cumulative catch-up method or the reallocation method is acceptable under the guide. Therefore, *Audits of Government Contractors* is amended so that its guidance on accounting for changes in estimates conforms to the recommendations in this statement. Also, since the recommendations in this statement provide more comprehensive and explicit guidance on the application of generally accepted accounting principles to contract accounting than does the guide, *Audits of Government Contractors*, the guide is amended to incorporate this statement as an appendix. The provisions of that guide should be interpreted and applied in the context of the recommendations in this statement.

.20 This statement is not intended to supersede recommendations on accounting in other AICPA industry accounting or audit guides or in other statements of position.

The Division's Conclusions

Determining a Basic Accounting Policy for Contracts

.21 In accounting for contracts, the basic accounting policy decision is the choice between the two generally accepted methods: the percentage-of-completion method including units of delivery

and the completed-contract method. The determination of which of the two methods is preferable should be based on a careful evaluation of circumstances because the two methods should not be acceptable alternatives for the same circumstances. The division's recommendations on basic accounting policy are set forth in the sections on "The Percentage-of-Completion Method" and "The Completed-Contract Method," which identify the circumstances appropriate to the methods, the bases of applying the methods, and the reasons for the recommendations. The recommendations apply to accounting for individual contracts and to accounting for other profit centers in accordance with the recommendations in the section on "Determining the Profit Center." As a result of evaluating individual contracts and profit centers, a contractor should be able to establish a basic policy that should be followed in accounting for most of his contracts. In accordance with the requirements of APB Opinion 22, *Disclosure of Accounting Policies*, a contractor should disclose in the note to the financial statements on accounting policies the method or methods of determining earned revenue and the cost of earned revenue including the policies relating to combining and segmenting, if applicable. Appendix C contains a summary of the disclosure requirements in this statement.

The Percentage-of-Completion Method

.22 This section sets forth the recommended basis for using the percentage-of-completion method and the reasons for the recommendation. Under most contracts for construction of facilities, production of goods, or provision of related services to a buyer's specifications, both the buyer and the seller (contractor) obtain enforceable rights. The legal right of the buyer to require specific performance of the contract means that the contractor has, in effect, agreed to sell his rights to work-in-progress as the work progresses. This view is consistent with the contractor's legal rights; he typically has no ownership claim to the work-in-progress but has lien rights. Furthermore, the contractor has the right to require the buyer, under most financing arrangements, to make progress payments to support his ownership investment and to approve the facilities constructed (or goods produced or services performed) to date if they meet the contract requirements. The buyer's right to take over the work-in-progress at his option (usually with a penalty) provides additional evidence to support that view. Accordingly, the business activity taking place supports the concept that in an economic sense performance is, in effect, a continuous sale (trans-

fer of ownership rights) that occurs as the work progresses. Also under most contracts for the production of goods and the provision of related services that are accounted for on the basis of units delivered, both the contractor and the customer obtain enforceable rights as the goods are produced or the services are performed. As units are delivered, title to and the risk of loss on those units normally transfer to the customer, whose acceptance of the items indicates that they meet the contractual specifications. For such contracts, delivery and acceptance are objective measurements of the extent to which the contracts have been performed. The percentage-of-completion method recognizes the legal and economic results of contract performance on a timely basis. Financial statements based on the percentage-of-completion method present the economic substance of a company's transactions and events more clearly and more timely than financial statements based on the completed-contract method, and they present more accurately the relationships between gross profit from contracts and related period costs. The percentage-of-completion method informs the users of the general purpose financial statements of the volume of economic activity of a company.

Circumstances Appropriate to the Method

.23 The use of the percentage-of-completion method depends on the ability to make reasonably dependable estimates. For the purposes of this statement, "the ability to make reasonably dependable estimates" relates to estimates of the extent of progress toward completion, contract revenues, and contract costs. The division believes that the percentage-of-completion method is preferable as an accounting policy in circumstances in which reasonably dependable estimates can be made and in which all the following conditions exist:

- Contracts executed by the parties normally include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement.
- The buyer can be expected to satisfy his obligations under the contract.
- The contractor can be expected to perform his contractual obligations.

.24 For entities engaged on a continuing basis in the production and delivery of goods or services under contractual arrangements and for whom contracting represents a significant part of their operations, the presumption is that they have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion method of accounting.⁴ Persuasive evidence to the contrary is necessary to overcome that presumption. The ability to produce reasonably dependable estimates is an essential element of the contracting business. For a contract on which a loss is anticipated, generally accepted accounting principles require recognition of the entire anticipated loss as soon as the loss becomes evident. An entity without the ability to update and revise estimates continually with a degree of confidence could not meet that essential requirement of generally accepted accounting principles.

.25 Accordingly, the division believes that entities with significant contracting operations generally have the ability to produce reasonably dependable estimates and that for such entities the percentage-of-completion method of accounting is preferable in most circumstances. The method should be applied to individual contracts or profit centers, as appropriate.

- a. Normally, a contractor will be able to estimate total contract revenue and total contract cost in single amounts. Those amounts should normally be used as the basis for accounting for contracts under the percentage-of-completion method.
- b. For some contracts, on which some level of profit is assured, a contractor may only be able to estimate total contract revenue and total contract cost in ranges of amounts. If, based on the information arising in estimating the ranges of amounts and all other pertinent data, the contractor can determine the amounts in the ranges that are most likely to occur, those amounts should be used in accounting for the contract under the percentage-of-completion method. If the most likely amounts cannot be determined, the lowest probable level of profit in the range should be used in accounting for the contract until the results can be estimated more precisely.

⁴The division recognizes that many contractors have informal estimating procedures that may result in poorly documented estimates and marginal quality field reporting and job costing systems. Those conditions may influence the ability of an entity to produce reasonably dependable estimates. However, procedures and systems should not influence the development of accounting principles and should be dealt with by management as internal control, financial reporting, and auditing concerns.

- c. However, in some circumstances, estimating the final outcome may be impractical except to assure that no loss will be incurred. In those circumstances, a contractor should use a zero estimate of profit; equal amounts of revenue and cost should be recognized until results can be estimated more precisely. A contractor should use this basis only if the bases in (a) or (b) are clearly not appropriate. A change from a zero estimate of profit to a more precise estimate should be accounted for as a change in an accounting estimate.

An entity using the percentage-of-completion method as its basic accounting policy should use the completed-contract method for a single contract or a group of contracts for which reasonably dependable estimates cannot be made or for which inherent hazards make estimates doubtful. Such a departure from the basic policy should be disclosed.

Nature of Reasonable Estimates and Inherent Hazards

.26 In practice, contract revenues and costs are estimated in a wide variety of ways ranging from rudimentary procedures to complex methods and systems. Regardless of the techniques used, a contractor's estimating procedures should provide reasonable assurance of a continuing ability to produce reasonably dependable estimates.⁵ Ability to estimate covers more than the estimating and documentation of contract revenues and costs; it covers a contractor's entire contract administration and management control system. The ability to produce reasonably dependable estimates depends on all the procedures and personnel that provide financial or production information on the status of contracts. It encompasses systems and personnel not only of the accounting department but of all areas of the company that participate in production control, cost control, administrative control, or accountability for contracts. Previous reliability of a contractor's estimating process is usually an indication of continuing reliability, particularly if the present circumstances are similar to those that prevailed in the past.

.27 Estimating is an integral part of contractors' business activities, and there is a necessity to revise estimates on contracts continually as the work progresses. The fact that circumstances

⁵The type of estimating procedures appropriate in a particular set of circumstances depends on a careful evaluation of the costs and benefits of developing the procedures. The ability to produce reasonably dependable estimates that would justify the use of the percentage-of-completion method as recommended in paragraph .25 does not depend on the elaborateness of the estimating procedures used.

may necessitate frequent revision of estimates does not indicate that the estimates are unreliable for the purpose for which they are used. Although results may differ widely from original estimates because of the nature of the business, the contractor, in the conduct of his business, may still find the estimates reasonably dependable. Despite these widely recognized conditions, a contractor's estimates of total contract revenue and total contract costs should be regarded as reasonably dependable if the minimum total revenue and the maximum total cost can be estimated with a sufficient degree of confidence to justify the contractor's bids on contracts.

.28 ARB 45 discourages the use of the percentage-of-completion method of accounting in circumstances in which inherent hazards make estimates doubtful. "Inherent hazards" relate to contract conditions or external factors that raise questions about contract estimates and about the ability of either the contractor or the customer to perform his obligations under the contract. Inherent hazards that may cause contract estimates to be doubtful usually differ from inherent business risks. Business enterprises engaged in contracting, like all business enterprises, are exposed to numerous business risks that vary from contract to contract. The reliability of the estimating process in contract accounting does not depend on the absence of such risks. Assessing business risks is a function of users of financial statements.

.29 The present business environment and the refinement of the estimating process have produced conditions under which most business entities engaged in contracting can deal adequately with the normal, recurring business risks in estimating the outcome of contracts. The division believes that inherent hazards that make otherwise reasonably dependable contract estimates doubtful involve events and conditions that would not be considered in the ordinary preparation of contract estimates and that would not be expected to recur frequently, given the contractor's normal business environment. Such hazards are unrelated to, or only incidentally related to, the contractor's typical activities. Such hazards may relate, for example, to contracts whose validity is seriously in question (that is, which are less than fully enforceable), to contracts whose completion may be subject to the outcome of pending legislation or pending litigation, or to contracts exposed to the possibility of the condemnation or expropriation of the resulting properties. Reasonably dependable estimates cannot be produced for a contract with unrealistic or ill-defined terms or for a contract be-

tween unreliable parties. However, the conditions stated in paragraph .23 for the use of the percentage-of-completion method of accounting, which apply to most bona fide contracts, make the existence of some uncertainties, including some of the type described in ARB 45, paragraph 15, unlikely for contracts that meet those conditions. Therefore, the division believes that there should be specific, persuasive evidence of such hazards to indicate that use of the percentage-of-completion method on one of the bases in paragraph .25 is not preferable.

The Completed-Contract Method

.30 This section sets forth the recommended basis for using the completed-contract method and the reasons for the recommendation. Under the completed-contract method, income is recognized only when a contract is completed or substantially completed. During the period of performance, billings and costs are accumulated on the balance sheet, but no profit or income is recorded before completion or substantial completion of the work. This method precludes reporting on the performance that is occurring under the enforceable rights of the contract as work progresses. Although the completed-contract method is based on results as finally determined rather than on estimates for unperformed work, which may involve unforeseen costs and possible losses, it does not reflect current performance when the period of a contract extends beyond one accounting period, and it therefore may result in irregular recognition of income. Financial statements based on this method may not show informative relationships between gross profit reported on contracts and related period costs.

Circumstances of Use

.31 The completed-contract method may be used as an entity's basic accounting policy in circumstances in which financial position and results of operations would not vary materially from those resulting from use of the percentage-of-completion method (for example, in circumstances in which an entity has primarily short-term contracts). Although this statement does not formally distinguish on the basis of length between long-term and short-term contracts, the basis for recording income on contracts of short duration poses relatively few problems. In accounting for such contracts, income ordinarily is recognized when performance is substantially completed and accepted. Under those circumstances,

revenues and costs in the aggregate for all contracts would be expected to result in a matching of gross profit with period overhead or fixed costs similar to that achieved by use of the percentage-of-completion method. For example, the completed-contract method, as opposed to the percentage-of-completion method, would not usually produce a material difference in net income or financial position for a small plumbing contractor that performs primarily relatively short-term contracts during an accounting period; performance covers such a short span of time that the work is somewhat analogous to the manufacture of shelf production items for sale. An entity using the completed-contract method as its basic accounting policy should depart from that policy for a single contract or a group of contracts not having the features described in this paragraph and use the percentage-of-completion method on one of the bases described in paragraph .25. Such a departure should be disclosed.

.32 The completed-contract method is preferable in circumstances in which estimates cannot meet the criteria for reasonable dependability discussed in the section on the percentage-of-completion method or in which there are inherent hazards of the nature of those discussed in that section. An entity using the percentage-of-completion method as its basic accounting policy should depart from that policy and use the completed-contract method for a single contract or a group of contracts only in the circumstances described in paragraph .25.

.33 The use of the completed-contract method is recommended for the circumstances described in paragraphs .31 and .32. However, for circumstances in which there is an assurance that no loss will be incurred on a contract (for example, when the scope of the contract is ill-defined but the contractor is protected by a cost-plus contract or other contractual terms), the percentage-of-completion method based on a zero profit margin, rather than the completed-contract method, is recommended until more precise estimates can be made. The significant difference between the percentage-of-completion method applied on the basis of a zero profit margin and the completed-contract method relates to the effects on the income statement. Under the zero profit margin approach to applying the percentage-of-completion method, equal amounts of revenue and cost, measured on the basis of performance during the period, are presented in the income statement;

whereas, under the completed-contract method, performance for a period is not reflected in the income statement, and no amount is presented in the income statement until the contract is completed. The zero profit margin approach to applying the percentage-of-completion method gives users of general purpose financial statements an indication of the volume of a company's business and of the application of its economic resources.

Determining the Profit Center

.34 The basic presumption should be that each contract is the profit center for revenue recognition, cost accumulation, and income measurement. That presumption may be overcome only if a contract or a series of contracts meets the conditions described for combining or segmenting contracts. A group of contracts (combining), and a phase or segment of a single contract or of a group of contracts (segmenting) may be used as a profit center in some circumstances. Since there are numerous practical implications of combining and segmenting contracts, evaluation of the circumstances, contract terms, and management intent are essential in determining contracts that may be accounted for on those bases.

Combining Contracts

.35 A group of contracts may be so closely related that they are, in effect, parts of a single project with an overall profit margin, and accounting for the contracts individually may not be feasible or appropriate. Under those circumstances, consideration should be given to combining such contracts for profit recognition purposes. The presumption in combining contracts is that revenue and profit are earned, and should be reported, uniformly over the performance of the combined contracts. For example, a group of construction-type contracts may be negotiated as a package with the objective of achieving an overall profit margin, although the profit margins on the individual contracts may vary. In those circumstances, if the individual contracts are performed and reported in different periods and accounted for separately, the reported profit margins in those periods will differ from the profit margin contemplated in the negotiations for reasons other than differences in performance.

.36 Contracts may be combined for accounting purposes only if they meet the criteria in paragraphs .37 and .38.

.37 A group of contracts may be combined for accounting purposes if the contracts

- a.* Are negotiated as a package in the same economic environment with an overall profit margin objective. Contracts not executed at the same time may be considered to have been negotiated as a package in the same economic environment only if the time period between the commitments of the parties to the individual contracts is reasonably short. The longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.
- b.* Constitute in essence an agreement to do a single project. A project for this purpose consists of construction, or related service activity with different elements, phases, or units of output that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose or use.
- c.* Require closely interrelated construction activities with substantial common costs that cannot be separately identified with, or reasonably allocated to, the elements, phases, or units of output.
- d.* Are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity.
- e.* Constitute in substance an agreement with a single customer. In assessing whether the contracts meet this criterion, the facts and circumstances relating to the other criteria should be considered. In some circumstances different divisions of the same entity would not constitute a single customer if, for example, the negotiations are conducted independently with the different divisions. On the other hand, two or more parties may constitute in substance a single customer if, for example, the negotiations are conducted jointly with the parties to do what in essence is a single project.

Contracts that meet all of these criteria may be combined for profit recognition and for determining the need for a provision for losses in accordance with ARB 45, paragraph 6. The criteria should be applied consistently to contracts with similar characteristics in similar circumstances.

.38 Production-type contracts that do not meet the criteria in paragraph .37 or segments of such contracts may be combined into groupings such as production lots or releases for the purpose of accumulating and allocating production costs to units produced or delivered on the basis of average unit costs in the following circumstances:⁶

- a. The contracts are with one or more customers for the production of substantially identical units of a basic item produced concurrently or sequentially.
- b. Revenue on the contracts is recognized on the units-of-delivery basis of applying the percentage-of-completion method.

Segmenting a Contract

.39 A single contract or a group of contracts that otherwise meet the test for combining may include several elements or phases, each of which the contractor negotiated separately with the same customer and agreed to perform without regard to the performance of the others. If those activities are accounted for as a single profit center, the reported income may differ from that contemplated in the negotiations for reasons other than differences in performance. If the project is segmented, revenues can be assigned to the different elements or phases to achieve different rates of profitability based on the relative value of each element or phase to the estimated total contract revenue. A project, which may consist of a single contract or a group of contracts, with segments that have different rates of profitability may be segmented if it meets the criteria in paragraph .40, paragraph .41, or paragraph .42. The criteria for segmenting should be applied consistently to contracts with similar characteristics and in similar circumstances.

.40 A project may be segmented if all the following steps were taken and are documented and verifiable:

- a. The contractor submitted bona fide proposals on the separate components of the project and on the entire project.
- b. The customer had the right to accept the proposals on either basis.

⁶The division is preparing a separate statement of position on program accounting, which will provide guidance on the circumstances in which existing and anticipated production-type contracts may be combined for the purpose of accumulating and allocating production costs.

- c. The aggregate amount of the proposals on the separate components approximated the amount of the proposal on the entire project.

.41 A project that does not meet the criteria in paragraph .40 may be segmented only if it meets all the following criteria:

- a. The terms and scope of the contract or project clearly call for separable phases or elements.
- b. The separable phases or elements of the project are often bid or negotiated separately.
- c. The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments.
- d. The contractor has a significant history of providing similar services to other customers under separate contracts for each significant segment to which a profit margin higher than the overall profit margin on the project is ascribed.⁷
- e. The significant history with customers who have contracted for services separately is one that is relatively stable in terms of pricing policy rather than one unduly weighted by erratic pricing decisions (responding, for example, to extraordinary economic circumstances or to unique customer-contractor relationships).
- f. The excess of the sum of the prices of the separate elements over the price of the total project is clearly attributable to cost savings incident to combined performance of the contract obligations (for example, cost savings in supervision, overhead, or equipment mobilization). Unless this condition is met, segmenting a contract with a price substantially less than the sum of the prices of the separate phases or elements would be inappropriate even if the other conditions are met. Acceptable price variations should be allocated to the separate phases or elements in proportion to the prices ascribed to each. In all other situations a substantial difference in price (whether more or less) between the separate elements and the price of the total project is evi-

⁷In applying the criterion in paragraph 41(d), values assignable to the segments should be on the basis of the contractor's normal historical prices and terms of such services to other customers. The division considered but rejected the concept of allowing a contractor to segment on the basis of prices charged by other contractors, since it does not follow that those prices could have been obtained by a contractor who has no history in the market

dence that the contractor has accepted different profit margins. Accordingly, segmenting is not appropriate, and the contracts should be the profit centers.

- g. The similarity of services and prices in the contract segments and services and the prices of such services to other customers contracted separately should be documented and verifiable.

.42 A production-type contract that does not meet the criteria in paragraphs .40 or .41 may also be segmented and included in groupings such as production lots or releases for the purpose of accumulating and allocating production costs to units produced or delivered on the basis of average unit cost under the conditions specified in paragraph .38.

Measuring Progress on Contracts

.43 This section describes methods of measuring the extent of progress toward completion under the percentage-of-completion method and sets forth criteria for selecting those methods and for determining when a contract is substantially completed. Meaningful measurement of the extent of progress toward completion is essential since this factor is used in determining the amounts of estimated contract revenue and estimated gross profit that will be recognized as earned in any given period.

Methods of Measuring Extent of Progress Toward Completion

.44 In practice, a number of methods are used to measure the extent of progress toward completion. They include the cost-to-cost method, variations of the cost-to-cost method, efforts-expended methods, the units-of-delivery method, and the units-of-work-performed method. Those practices are intended to conform to ARB 45, paragraph 4.⁸ Some of the measures are sometimes made and certified by engineers or architects, but manage-

⁸ARB 45, paragraph 4, states

The committee recommends that the recognized income [under the percentage-of-completion method] be that percentage of estimated total income, either

- (a) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or
- (b) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income

ment should review and understand the procedures used by those professionals.

.45 Some methods used in practice measure progress toward completion in terms of costs, some in terms of units of work, and some in terms of values added (the contract value of total work performed to date). All three of these measures of progress are acceptable in appropriate circumstances. The division concluded that other methods that achieve the objective of measuring extent of progress toward completion in terms of costs, units, or value added are also acceptable in appropriate circumstances. However, the method or methods selected should be applied consistently to all contracts having similar characteristics. The method or methods of measuring extent of progress toward completion should be disclosed in the notes to the financial statements. Examples of circumstances not appropriate to some methods are given within the discussion of input and output measures.

Input and Output Measures

.46 The several approaches to measuring progress on a contract can be grouped into input and output measures. Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed. In other circumstances, progress may be measured, for example, on the basis of cubic yards of excavation for foundation contracts or on the basis of cubic yards of pavement laid for highway contracts.

.47 Both input and output measures have drawbacks in some circumstances. Input is used to measure progress toward completion indirectly, based on an established or assumed relationship between a unit of input and productivity. A significant drawback of input measures is that the relationship of the measures to productivity may not hold, because of inefficiencies or other factors. Output is used to measure results directly and is generally the best measure of progress toward completion in circumstances in which a reliable measure of output can be established. However, output

measures often cannot be established, and input measures must then be used. The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances.

.48 The efforts-expended method is an input method based on a measure of the work, such as labor hours, labor dollars, machine hours, or material quantities. Under the labor-hours method, for example, extent of progress is measured by the ratio of hours performed to date to estimated total hours at completion. Estimated total labor hours should include (a) the estimated labor hours of the contractor and (b) the estimated labor hours of subcontractors engaged to perform work for the project, if labor hours of subcontractors are a significant element in the performance of the contract. A labor-hours method can measure the extent of progress in terms of efforts expended only if substantial efforts of subcontractors are included in the computation. If the contractor is unable to obtain reasonably dependable estimates of subcontractors' labor hours at the beginning of the project and as work progresses, he should not use the labor-hours method.

.49 The various forms of the efforts-expended method generally are based on the assumption that profits on contracts are derived from the contractor's efforts in all phases of operations, such as designing, procurement, and management. Profit is not assumed to accrue merely as a result of the acquisition of material or other tangible items used in the performance of the contract or the awarding of subcontracts. As previously noted, a significant drawback of efforts-expended methods is that the efforts included in the measure may not all be productive.

.50 Measuring progress toward completion based on the ratio of costs incurred to total estimated costs is also an input method. Some of the costs incurred, particularly in the early stages of the contract, should be disregarded in applying this method because they do not relate to contract performance. These include the costs of items such as uninstalled materials not specifically produced or fabricated for the project or of subcontracts that have not been performed. For example, for construction projects, the cost of materials not unique to the project that have been purchased or ac-

cumulated at job sites but that have not been physically installed do not relate to performance.⁹ The costs of such materials should be excluded from costs incurred for the purpose of measuring the extent of progress toward completion. Also, the cost of equipment purchased for use on a contract should be allocated over the period of its expected use unless title to the equipment is transferred to the customer by terms of the contract. For production-type contracts, the complement of expensive components (for example, computers, engines, radars, and complex "black boxes") to be installed into the deliverable items may aggregate a significant portion of the total cost of the contract. In some circumstances, the costs incurred for such components, even though the components were specifically purchased for the project, should not be included in the measurement before the components are installed if inclusion would tend to overstate the percentage of completion otherwise determinable.

.51 The acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

Completion Criteria Under the Completed-Contract Method

.52 As a general rule, a contract may be regarded as substantially completed if remaining costs and potential risks are insignificant in amount. The overriding objectives are to maintain consistency in determining when contracts are substantially completed and to avoid arbitrary acceleration or deferral of income. The specific criteria used to determine when a contract is substantially completed should be followed consistently and should be disclosed in the note to the financial statements on accounting policies. Circumstances to be considered in determining when a project is

⁹The cost of uninstalled materials specifically produced, fabricated, or constructed for a project should be included in the costs used to measure extent of progress. Such materials consist of items unique to a project that a manufacturer or supplier does not carry in inventory and that must be produced or altered to meet the specifications of the project

substantially completed include, for example, delivery of the product, acceptance by the customer, departure from the site, and compliance with performance specifications.

Income Determination—Revenue Elements

.53 Estimating the revenue on a contract is an involved process, which is affected by a variety of uncertainties that depend on the outcome of a series of future events. The estimates must be periodically revised throughout the life of the contract as events occur and as uncertainties are resolved.

.54 The major factors that must be considered in determining total estimated revenue include the basic contract price, contract options, change orders, claims, and contract provisions for penalties and incentive payments, including award fees and performance incentives. All those factors and other special contract provisions must be evaluated throughout the life of a contract in estimating total contract revenue to recognize revenues in the periods in which they are earned under the percentage-of-completion method of accounting.

Basic Contract Price—General

.55 The estimated revenue from a contract is the total amount that a contractor expects to realize from the contract. It is determined primarily by the terms of the contract and the basic contract price. Contract price may be relatively fixed or highly variable and subject to a great deal of uncertainty, depending on the type of contract involved. Appendix B describes basic contract types and major variations in the basic types. The total amount of revenue that ultimately will be realized on a contract is often subject to a variety of changing circumstances and accordingly may not be known with certainty until the parties to the contract have fully performed their obligations. Thus, the determination of total estimated revenue requires careful consideration and the exercise of judgment in assessing the probabilities of future outcomes.

.56 Although fixed-price contracts usually provide for a stated contract price, a specified scope of the work to be performed, and a specified performance schedule, they sometimes have adjustment schedules based on application of economic price adjustment (esca-

lation), price redetermination, incentive, penalty, and other pricing provisions. Determining contract revenue under unit-price contracts generally involves the same factors as under fixed-price contracts. Determining contract revenue from a time-and-material contract requires a careful analysis of the contract, particularly if the contract includes guaranteed maximums or assigns markups to both labor and materials; and the determination involves consideration of some of the factors discussed below in regard to cost-type contracts.

Basic Contract Price—Cost-Type Contracts

.57 Cost-type contracts have a variety of forms (see Appendix B). The various forms have differing contract terms that affect accounting, such as provisions for reimbursable costs (which are generally spelled out in the contract), overhead recovery percentages, and fees. A fee may be a fixed amount or a percentage of reimbursable costs or an amount based on performance criteria.¹⁰ Generally, percentage fees may be accrued as the related costs are incurred, since they are a percentage of costs incurred, and profits should therefore be recognized as costs are incurred. Cost-type contracts often include provisions for guaranteed maximum total reimbursable costs or target penalties and rewards relating to underruns and overruns of predetermined target prices, completion dates, plant capacity on completion of the project, or other criteria.

.58 One problem peculiar to cost-type contracts involves the determination of the amounts of reimbursable costs that should be reflected as revenue. Under some contracts, particularly service-type contracts, a contractor acts solely in the capacity of an agent (construction manager) and has no risks associated with costs managed. This relationship may arise, for example, if an owner awards a construction management contract to one entity and a construction contract to another. If the contractor, serving as the construction manager, acts solely as an agent, his revenue should include only the fee and should exclude subcontracts negotiated or managed on behalf of the owner and materials purchased on behalf of the owner.

¹⁰Cost-type government contracts with fees based on a percentage of cost are no longer granted under government regulations

.59 In other circumstances, a contractor acts as an ordinary principal under a cost-type contract. For example, the contractor may be responsible to employees for salaries and wages and to subcontractors and other creditors for materials and services, and he may have the discretionary responsibility to procure and manage the resources in performing the contract. The contractor should include in revenue all reimbursable costs for which he has risk or on which his fee was based at the time of bid or negotiation. In addition, revenue from overhead percentage recoveries and the earned fee should be included in revenue.

Customer-Furnished Materials

.60 Another concern associated with measuring revenue relates to materials furnished by a customer or purchased by the contractor as an agent for the customer. Often, particularly for large, complex projects, customers may be more capable of carrying out the procurement function or may have more leverage with suppliers than the contractor. In those circumstances, the contractor generally informs the customer of the nature, type, and characteristics or specifications of the materials required and may even purchase the required materials and pay for them, using customer purchase orders and checks drawn against the customer's bank account. If the contractor is responsible for the nature, type, characteristics, or specifications of material that the customer furnishes or that the contractor purchases as an agent of the customer, or if the contractor is responsible for the ultimate acceptability of performance of the project based on such material, the value of those items should be included as contract price and reflected as revenue and costs in periodic reporting of operations. As a general rule, revenues and costs should include all items for which the contractor has an associated risk, including items on which his contractual fee was based.

Change Orders

.61 Change orders are modifications of an original contract that effectively change the provisions of the contract without adding new provisions. They may be initiated by either the contractor or the customer, and they include changes in specifications or design, method or manner of performance, facilities, equipment, materials, site, and period for completion of the work. Many change orders are unpriced; that is, the work to be performed is defined, but the adjustment to the contract price is to be negotiated later. For some change orders, both scope and price may be unapproved

or in dispute. Accounting for change orders depends on the underlying circumstances, which may differ for each change order depending on the customer, the contract, and the nature of the change. Change orders should therefore be evaluated according to their characteristics and the circumstances in which they occur. In some circumstances, change orders as a normal element of a contract may be numerous, and separate identification may be impractical. Such change orders may be evaluated statistically on a composite basis using historical results as modified by current conditions. If such change orders are considered by the parties to be a normal element within the original scope of the contract, no change in the contract price is required. Otherwise, the adjustment to the contract price may be routinely negotiated. Contract revenue and costs should be adjusted to reflect change orders approved by the customer and the contractor regarding both scope and price.

.62 Accounting for unpriced change orders depends on their characteristics and the circumstances in which they occur. Under the completed-contract method, costs attributable to unpriced change orders should be deferred as contract costs if it is probable that aggregate contract costs, including costs attributable to change orders, will be recovered from contract revenues. For all unpriced change orders, recovery should be deemed probable if the future event or events necessary for recovery are likely to occur. Some of the factors to consider in evaluating whether recovery is probable are the customer's written approval of the scope of the change order, separate documentation for change order costs that are identifiable and reasonable, and the entity's favorable experience in negotiating change orders, especially as it relates to the specific type of contract and change order being evaluated. The following guidelines should be followed in accounting for unpriced change orders under the percentage-of-completion method.

- a. Costs attributable to unpriced change orders should be treated as costs of contract performance in the period in which the costs are incurred if it is *not* probable that the costs will be recovered through a change in the contract price.
- b. If it is probable that the costs will be recovered through a change in the contract price, the costs should be deferred (excluded from the cost of contract performance) until the parties have agreed on the change in contract price, or, alternatively, they

should be treated as costs of contract performance in the period in which they are incurred, and contract revenue should be recognized to the extent of the costs incurred.

- c. If it is probable that the contract price will be adjusted by an amount that exceeds the costs attributable to the change order and the amount of the excess can be reliably estimated, the original contract price should also be adjusted for that amount when the costs are recognized as costs of contract performance if its realization is probable. However, since the substantiation of the amount of future revenue is difficult, revenue in excess of the costs attributable to unpriced change orders should only be recorded in circumstances in which realization is assured beyond a reasonable doubt, such as circumstances in which an entity's historical experience provides such assurance or in which an entity has received a bona fide pricing offer from a customer and records only the amount of the offer as revenue.

.63 If change orders are in dispute or are unapproved in regard to both scope and price, they should be evaluated as claims (see paragraphs .65 to .67).

Contract Options and Additions

.64 An option or an addition to an existing contract should be treated as a separate contract in any of the following circumstances:

- a. The product or service to be provided differs significantly from the product or service provided under the original contract.
- b. The price of the new product or service is negotiated without regard to the original contract and involves different economic judgments.
- c. The products or services to be provided under the exercised option or amendment are similar to those under the original contract, but the contract price and anticipated contract cost relationship are significantly different.

However, even if the separate contract does not meet any of these conditions, it may be combined with the original contract if the contracts meet the criteria in paragraph .37 or .38. Exercised options or additions that do not meet the criteria for treatment as separate contracts or as separate contracts combined with the original contracts should be treated as change orders on the original contracts.

Claims

.65 Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs. Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of all the following conditions:

- a. The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.
- b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance.
- c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.
- d. The evidence supporting the claim is objective and verifiable, not based on management's "feel" for the situation or on unsupported representations.

If the foregoing requirements are met, revenue from a claim should be recorded only to the extent that contract costs relating to the claim have been incurred. The amounts recorded, if material, should be disclosed in the notes to the financial statements. Costs attributable to claims should be treated as costs of contract performance as incurred.

.66 However, a practice such as recording revenues from claims only when the amounts have been received or awarded may be used. If that practice is followed, the amounts should be disclosed in the notes to the financial statements.

.67 If the requirements in paragraph .65 are not met or if those requirements are met but the claim exceeds the recorded contract costs, a contingent asset should be disclosed in accordance with FASB Statement no. 5, paragraph 17.

Income Determination—Cost Elements

.68 Contract costs must be identified, estimated, and accumulated with a reasonable degree of accuracy in determining income earned. At any time during the life of a contract, total estimated contract cost consists of two components: costs incurred to date and estimated cost to complete the contract. A company should be able to determine costs incurred on a contract with a relatively high degree of precision, depending on the adequacy and effectiveness of its cost accounting system. The procedures or systems used in accounting for costs vary from relatively simple, manual procedures that produce relatively modest amounts of detailed analysis to sophisticated, computer-based systems that produce a great deal of detailed analysis. Despite the diversity of systems and procedures, however, an objective of each system or of each set of procedures should be to accumulate costs properly and consistently by contract with a sufficient degree of accuracy to assure a basis for the satisfactory measurement of earnings.

Contract Costs

.69 Contract costs are accumulated in the same manner as inventory costs and are charged to operations as the related revenue from contracts is recognized. Contract costs generally include all direct costs, such as materials, direct labor, and subcontracts, and indirect costs identifiable with or allocable to the contracts. However, practice varies for certain types of indirect costs considered allocable to contracts, for example, support costs (such as central preparation and processing of job payrolls, billing and collection costs, and bidding and estimating costs).

.70 Authoritative accounting pronouncements require costs to be considered period costs if they cannot be clearly related to production, either directly or by an allocation based on their discernible future benefits.

.71 Income is recognized over the term of the contract under the percentage-of-completion method or is recognized as units are delivered under the units-of-delivery modification and is deferred until performance is substantially complete under the completed-contract method. None of the characteristics peculiar to those methods, however, require accounting for contract costs to deviate in principle from the basic framework established in existing authoritative literature applicable to inventories or business enterprises in general.

.72 A contracting entity should apply the following general principles in accounting for costs of construction-type and those production-type contracts covered by this statement. The principles are consistent with generally accepted accounting principles for inventory and production costs in other areas, and their application requires the exercise of judgment.

- a. All direct costs, such as material, labor, and subcontracting costs, should be included in contract costs.
- b. Indirect costs allocable to contracts include the costs of indirect labor, contract supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and, in some circumstances, support costs, such as central preparation and processing of payrolls. For government contractors, other types of costs that are allowable or allocable under pertinent government contract regulations may be allocated to contracts as indirect costs if otherwise allowable under GAAP.¹¹ Methods of allocating indirect costs should be systematic and rational. They include, for example, allocations based on direct labor costs, direct labor hours, or a combination of direct labor and material costs. The appropriateness of allocations of indirect costs and of the methods of allocation depend on the circumstances and involve judgment.
- c. General and administrative costs ordinarily should be charged to expense as incurred but may be accounted for as contract costs under the completed-contract method of accounting¹² or, in some circumstances, as indirect contract costs by government contractors.¹³

¹¹The AICPA industry audit guide, *Audits of Government Contractors*, states, "Practice varies among government contractors as to the extent to which costs are included in inventory. Some contractors include all direct costs and only certain indirect costs. Other contractors record in inventory accounts all costs identified with the contract including allocated general and administrative expenses." The guide points out that many accountants believe that the practice of allocating general and administrative expenses to contract costs, which is permitted under the completed-contract method by ARB 45, paragraph 10, may appropriately be extended to government contracts because they believe that all costs under the contract are directly associated with the contract revenue, and both should be recognized in the same period."

¹²Paragraph 10 of ARB 45, *Long Term Construction-Type Contracts*, states

When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period cost, particularly in years when no contracts were completed.

¹³See the discussion of the AICPA industry audit guide, *Audits of Government Contractors*, in footnote 11.

- d. Selling costs should be excluded from contract costs and charged to expense as incurred unless they meet the criteria for precontract costs in paragraph .75.
- e. Costs under cost-type contracts should be charged to contract costs in conformity with generally accepted accounting principles in the same manner as costs under other types of contracts because unrealistic profit margins may result in circumstances in which reimbursable cost accumulations omit substantial contract costs (with a resulting larger fee) or include substantial unallocable general and administrative costs (with a resulting smaller fee).
- f. In computing estimated gross profit or providing for losses on contracts, estimates of cost to complete should reflect all of the types of costs included in contract costs.
- g. Inventoriable costs should not be carried at amounts that when added to the estimated cost to complete are greater than the estimated realizable value of the related contracts.

Interest costs should be accounted for in accordance with FASB Statement no. 34, *Capitalization of Interest Cost*.

Precontract Costs

.73 In practice, costs are deferred in anticipation of future contract sales in a variety of circumstances. The costs may consist of (a) costs incurred in anticipation of a specific contract that will result in no future benefit unless the contract is obtained (such as the costs of mobilization, engineering, architectural, or other services incurred on the basis of commitments or other indications of interest in negotiating a contract), (b) costs incurred for assets to be used in connection with specific anticipated contracts (for example, costs for the purchase of production equipment, materials, or supplies), (c) costs incurred to acquire or produce goods in excess of the amounts required under a contract in anticipation of future orders for the same item, and (d) learning, start-up, or mobilization costs incurred for anticipated but unidentified contracts.

.74 Learning or start-up costs are sometimes incurred in connection with the performance of a contract or a group of contracts. In some circumstances, follow-on or future contracts for the same goods or services are anticipated. Such costs usually consist of labor, overhead, rework, or other special costs that must be in-

curred to complete the existing contract or contracts in progress and are distinguished from research and development costs.¹⁴ A direct relationship between such costs and the anticipated future contracts is often difficult to establish, and the receipt of future contracts often cannot reasonably be anticipated.

.75 The division recommends the following accounting for pre-contract costs:

- a. Costs that are incurred for a specific anticipated contract and that will result in no future benefits unless the contract is obtained should not be included in contract costs or inventory before the receipt of the contract. However, such costs may be otherwise deferred, subject to evaluation of their probable recoverability, but only if the costs can be directly associated with a specific anticipated contract and if their recoverability from that contract is probable.
- b. Costs incurred for assets, such as costs for the purchase of materials, production equipment, or supplies, that are expected to be used in connection with anticipated contracts may be deferred outside the contract cost or inventory classification if their recovery from future contract revenue or from other dispositions of the assets is probable.
- c. Costs incurred to acquire or produce goods in excess of the amounts required for an existing contract in anticipation of future orders for the same items may be treated as inventory if their recovery is probable.
- d. Learning or start-up costs incurred in connection with existing contracts and in anticipation of follow-on or future contracts for the same goods or services should be charged to existing contracts.¹⁵
- e. Costs appropriately deferred in anticipation of a contract should be included in contract costs on the receipt of the anticipated contract.
- f. Costs related to anticipated contracts that are charged to expenses as incurred because their recovery is not considered

¹⁴Statement of Financial Accounting Standards no. 2, *Accounting for Research and Development Costs*, requires that research and development costs be charged to expense when incurred

¹⁵See footnote 3, which indicates that the division is preparing a statement of position on program accounting for consideration by the FASB.

probable should not be reinstated by a credit to income on the subsequent receipt of the contract.

Cost Adjustments Arising from Back Charges

.76 Back charges are billings for work performed or costs incurred by one party that, in accordance with the agreement, should have been performed or incurred by the party to whom billed. These frequently are disputed items. For example, owners bill back charges to general contractors, and general contractors bill back charges to subcontractors. Examples of back charges include charges for cleanup work and charges for a subcontractor's use of a general contractor's equipment.

.77 A common practice is to net back charges in the estimating process. The division recommends the following procedures in accounting for back charges:

- Back charges to others should be recorded as receivables and, to the extent considered collectible, should be applied to reduce contract costs. However, if the billed party disputes the propriety or amount of the charge, the back charge is in effect a claim, and the criteria for recording claims apply.
- Back charges from others should be recorded as payables and as additional contract costs to the extent that it is probable that the amounts will be paid.

Estimated Cost to Complete

.78 The estimated cost to complete, the other component of total estimated contract cost, is a significant variable in the process of determining income earned and is thus a significant factor in accounting for contracts. The latest estimate may be determined in a variety of ways and may be the same as the original estimate. Practices in estimating total contract costs vary, and guidance is needed in this area because of the impact of those practices on accounting. The following practices should be followed:

- a. Systematic and consistent procedures that are correlated with the cost accounting system should be used to provide a basis for periodically comparing actual and estimated costs.
- b. In estimating total contract costs, the quantities and prices of all significant elements of cost should be identified.

- c. The estimating procedures should provide that estimated cost to complete includes the same elements of cost that are included in actual accumulated costs; also, those elements should reflect expected price increases.
- d. The effects of future wage and price escalations should be taken into account in cost estimates, especially when the contract performance will be carried out over a significant period of time. Escalation provisions should not be blanket overall provisions but should cover labor, materials, and indirect costs based on percentages or amounts that take into consideration experience and other pertinent data.
- e. Estimates of cost to complete should be reviewed periodically and revised as appropriate to reflect new information.

Computation of Income Earned for a Period Under the Percentage-of-Completion Method

.79 Total estimated gross profit on a contract, the difference between total estimated contract revenue and total estimated contract cost, must be determined before the amount earned on the contract for a period can be determined. The portion of total revenue earned or the total amount of gross profit earned to date is determined by the measurement of the extent of progress toward completion using one of the methods discussed in paragraphs .44 to .51 of this statement. The computation of income earned for a period involves a determination of the portion of total estimated contract revenue that has been earned to date (earned revenue) and the portion of total estimated contract cost related to that revenue (cost of earned revenue). Two different approaches to determining earned revenue and cost of earned revenue are widely used in practice. Either of the alternative approaches may be used on a consistent basis.¹⁶

Alternative A

.80 The advocates of this method believe that the portion of total estimated contract revenue earned to date should be determined by the measurement of the extent of progress toward completion and that, in accordance with the matching concept, the

¹⁶The use of Alternative A in the discussion and in the presentation of some of the provisions of this statement is for convenience and consistency and is not intended to imply that Alternative A is the preferred approach

measurement of extent of progress toward completion should also be used to allocate a portion of total estimated contract cost to the revenue recognized for the period. They believe that this procedure results in reporting earned revenue, cost of earned revenue, and gross profit consistent with the measurement of contract performance. Moreover, they believe that, if there are no changes in estimates during the performance of a contract, the procedure also results in a consistent gross profit percentage from period to period. However, they recognize that a consistent gross profit percentage is rarely obtained in practice because of the need to be responsive in the accounting process to changes in estimates of contract revenues, costs, earned revenue, and gross profits. In accordance with this procedure, earned revenue, cost of earned revenue, and gross profit should be determined as follows:

- a. *Earned Revenue* to date should be computed by multiplying total estimated contract revenue by the percentage of completion (as determined by one of the acceptable methods of measuring the extent of progress toward completion). The excess of the amount over the earned revenue reported in prior periods is the earned revenue that should be recognized in the income statement for the current period.
- b. *Cost of Earned Revenue* for the period should be computed in a similar manner. Cost of earned revenue to date should be computed by multiplying total estimated contract cost by the percentage of completion on the contract. The excess of that amount over the cost of earned revenue reported in prior periods is the cost of earned revenue that should be recognized in the income statement for the current period. The difference between total cost incurred to date and cost of earned revenue to date should be reported on the balance sheet.
- c. *Gross Profit* on a contract for a period is the excess of earned revenue over the cost of earned revenue.

Alternative B

.81 The advocates of this method believe that the measurement of the extent of progress toward completion should be used to determine the amount of gross profit earned to date and that the earned revenue to date is the sum of the total cost incurred on the contract and the amount of gross profit earned. They believe that the cost of work performed on a contract for a period, including

materials, labor, subcontractors, and other costs, should be the cost of earned revenue for the period. They believe that the amount of costs incurred can be objectively determined, does not depend on estimates, and should be the amount that enters into the accounting determination of income earned. They recognize that, under the procedure that they advocate, gross profit percentages will vary from period to period unless the cost-to-cost method is used to measure the extent of progress toward completion. However, they believe that varying profit percentages are consistent with the existing authoritative literature when costs incurred do not provide an appropriate measure of the extent of progress toward completion. In accordance with Alternative B, earned revenue, cost of earned revenue, and gross profit are determined as follows:

- a. *Earned Revenue* is the amount of gross profit earned on a contract for a period plus the costs incurred on the contract during the period.
- b. *Cost of Earned Revenue* is the cost incurred during the period, excluding the cost of materials not unique to a contract that have not been used for the contract and costs incurred for subcontracted work that is still to be performed.
- c. *Gross Profit* earned on a contract should be computed by multiplying the total estimated gross profit on the contract by the percentage of completion (as determined by one of the acceptable methods of measuring extent of progress toward completion). The excess of that amount over the amount of gross profit reported in prior periods is the earned gross profit that should be recognized in the income statement for the current period.

Revised Estimates

.82 Adjustments to the original estimates of the total contract revenue, total contract cost, or extent of progress toward completion are often required as work progresses under the contract and as experience is gained, even though the scope of the work required under the contract may not change. The nature of accounting for contracts is such that refinements of the estimating process for changing conditions and new developments are continuous and characteristic of the process. Additional information that enhances and refines the estimating process is often obtained after the balance sheet date but before the issuance of the financial statements;

such information should result in an adjustment of the unissued financial statements. Events occurring after the date of the financial statements that are outside the normal exposure and risk aspects of the contract should not be considered refinements of the estimating process of the prior year but should be disclosed as subsequent events.

.83 Revisions in revenue, cost, and profit estimates or in measurements of the extent of progress toward completion are changes in accounting estimates as defined in APB Opinion 20, *Accounting Changes*.¹⁷ That opinion has been interpreted to permit the following two alternative methods of accounting for changes in accounting estimates:

- *Cumulative Catch-up*. Account for the change in estimate in the period of change so that the balance sheet at the end of the period of change and the accounting in subsequent periods are as they would have been if the revised estimate had been the original estimate.
- *Reallocation*. Account for the effect of the change ratably over the period of change in estimate and subsequent periods.

Although both methods are used in practice to account for changes in estimates of total revenue, total costs, or extent of progress under the percentage-of-completion method, the cumulative catch-up method is more widely used. Accordingly, to narrow the areas of differences in practice, such changes should be accounted for by the cumulative catch-up method.

.84 Although estimating is a continuous and normal process for contractors, the second sentence of APB Opinion 20, paragraph 33, recommends disclosure of the effect of significant revisions if the effect is material.¹⁸

¹⁷Paragraph 31 of APB Opinion 20, *Accounting Changes*, requires that "the effect of a change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both "

¹⁸APB Opinion 20, paragraph 33, states,

The effect on income before extraordinary items, net income and related per share amounts of the current period should be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence, however, disclosure is recommended if the effect of a change in the estimate is material

Provisions for Anticipated Losses on Contracts

.85 When the current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract should be made. Provisions for losses should be made in the period in which they become evident under either the percentage-of-completion method or the completed-contract method. If a group of contracts are combined based on the criteria in paragraph .37 or .38, they should be treated as a unit in determining the necessity for a provision for a loss. If contracts are segmented based on the criteria in paragraph .40, .41, or .42 of this statement, the individual segments should be considered separately in determining the need for a provision for a loss.

.86 Losses on cost-type contracts, although less frequent, may arise if, for example, a contract provides for guaranteed maximum reimbursable costs or target penalties. In recognizing losses for accounting purposes, the contractor's normal cost accounting methods should be used in determining the total cost overrun on the contract, and losses should include provisions for performance penalties.

.87 The costs used in arriving at the estimated loss on a contract should include all costs of the type allocable to contracts under paragraph .72 of this statement. Other factors that should be considered in arriving at the projected loss on a contract include target penalties and rewards, nonreimbursable costs on cost-plus contracts, change orders, and potential price redeterminations. In circumstances in which general and administrative expenses are treated as contract costs under the completed-contract method of accounting, the estimated loss should include the same types of general and administrative expenses.

.88 The provision for loss arises because estimated cost for the contract exceeds estimated revenue. Consequently, the provision for loss should be accounted for in the income statement as an additional contract cost rather than as a reduction of contract revenue, which is a function of contract price, not cost. Unless the provision is material in amount or unusual or infrequent in nature, the provision should be included in contract cost and need not be shown separately in the income statement. If it is shown separately, it should be shown as a component of the cost included in the computation of gross profit.

.89 Provisions for losses on contracts should be shown separately as liabilities on the balance sheet, if significant, except in circumstances in which related costs are accumulated on the balance sheet, in which case the provisions may be deducted from the related accumulated costs. In a classified balance sheet, a provision shown as a liability should be shown as a current liability.

Transition

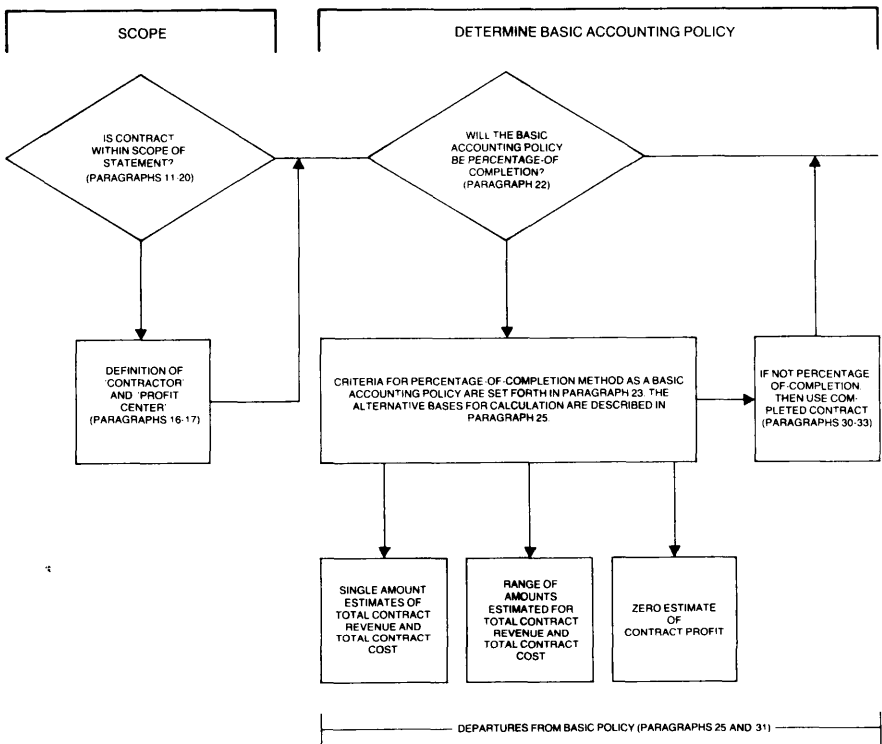
.90 An accounting change from the completed-contract method or from the percentage-of-completion method to conform to the recommendations of this statement of position should be made retroactively by restating the financial statements of prior periods. The restatement should be made on the basis of current information if historical information is not available. If the information for restatement of prior periods is not available on either a historical or current basis, financial statements and summaries should be restated for as many consecutive prior periods preceding the transition date of this statement as is practicable, and the cumulative effect on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which the statement is first applied if it is not practicable to restate any prior periods) should be included in determining net income for that period (see paragraph 20 of APB Opinion 20, *Accounting Changes*).

.91 Accounting changes to conform to the recommendations of this statement of position, other than those stated in paragraph .90, should be made prospectively for contracting transactions, new contracts, and contract revisions entered into on or after the effective date of this statement. The division recommends the application of the provisions of this statement for fiscal years, and interim periods in such fiscal years, beginning after June 30, 1981. The division encourages earlier application of this statement, including retroactive application to all contracts regardless of when they were entered into. Disclosures should be made in the financial statements in the period of change in accordance with APB Opinion 20, paragraph 28.

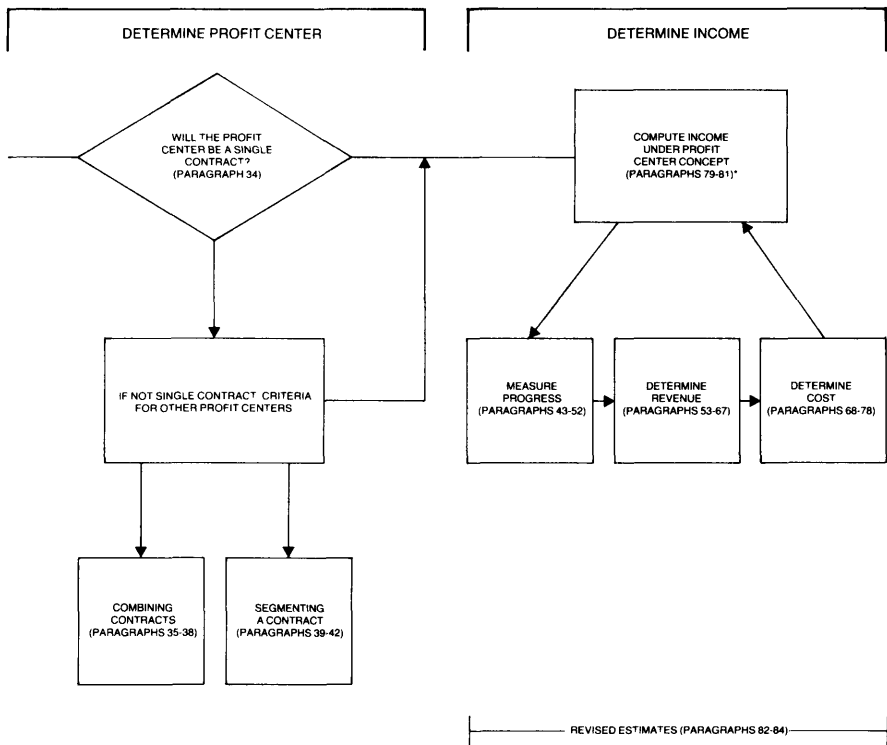
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APPENDIX A

Schematic Chart of SOP Organization



NOTE: ALL PARAGRAPH NUMBERS ABOVE REFER TO TEXT OF SOP
 *If computation results in a loss, see paragraphs 85-89



APPENDIX B

Types of Contracts

Four basic types of contracts are distinguished on the basis of their pricing arrangements in paragraph .15 of this statement: (a) fixed-price or lump-sum contracts, (b) time-and-material contracts, (c) cost-type (including cost-plus) contracts, and (d) unit-price contracts. This appendix describes the basic types of contracts in greater detail and briefly describes common variations of each basic type.

Fixed-Price or Lump-Sum Contracts

A fixed-price or lump-sum contract is a contract in which the price is not usually subject to adjustment because of costs incurred by the contractor. Common variations of fixed-price contracts are

1. *Firm fixed-price contract*—A contract in which the price is not subject to any adjustment by reason of the cost experience of the contractor or his performance under the contract.
2. *Fixed-price contract with economic price adjustment*—A contract which provides for upward or downward revision of contract price upon the occurrence of specifically defined contingencies, such as increases or decreases in material prices or labor wage rates.
3. *Fixed-price contract providing for prospective periodic redetermination of price*—A contract which provides a firm fixed-price for an initial number of unit deliveries or for an initial period of performance and for prospective price redeterminations either upward or downward at stated intervals during the remaining period of performance under the contract.
4. *Fixed-price contract providing for retroactive redetermination of price*—A contract which provides for a ceiling price and retroactive price redetermination (within the ceiling price) after the completion of the contract, based on costs incurred, with consideration being given to management ingenuity and effectiveness during performance.
5. *Fixed-price contract providing for firm target cost incentives*—A contract which provides at the outset for a firm target cost, a firm target profit, a price ceiling (but not a profit ceiling or floor), and a formula (based on the relationship which final negotiated total cost bears to total target cost) for establishing final profit and price.
6. *Fixed-price contract providing for successive target cost incentives*—A contract which provides at the outset for an initial target cost, an initial target profit, a price ceiling, a formula for subsequently fixing the firm

target profit (within a ceiling and a floor established along with the formula, at the outset), and a production point at which the formula will be applied.

7. *Fixed-price contract providing for performance incentives*—A contract which incorporates an incentive to the contractor to surpass stated performance targets by providing for increases in the profit to the extent that such targets are surpassed and for decreases to the extent that such targets are not met.

8. *Fixed-price level-of-effort term contract*—A contract which usually calls for investigation or study in a specific research and development area. It obligates the contractor to devote a specified level of effort over a stated period of time for a fixed dollar amount.¹

Time-and-Material Contracts

Time-and-material contracts are contracts that generally provide for payments to the contractor on the basis of direct labor hours at fixed hourly rates (that cover the cost of direct labor and indirect expenses and profit) and cost of materials or other specified costs. Common variations of time and material contracts are

1. Time at marked-up rate.
2. Time at marked-up rate, material at cost.
3. Time and material at marked-up rates.
4. Guaranteed maximum cost—labor only or labor and material.

Cost-Type Contracts

Cost-type contracts provide for reimbursement of allowable or otherwise defined costs incurred plus a fee that represents profit. Cost-type contracts usually only require that the contractor use his best efforts to accomplish the scope of the work within some specified time and some stated dollar limitation. Common variations of cost-plus contracts are

1. *Cost-sharing contract*—A contract under which the contractor is reimbursed only for an agreed portion of costs and under which no provision is made for a fee.
2. *Cost-without-fee contract*—A contract under which the contractor is reimbursed for costs with no provision for a fee.

¹AICPA Industry Audit Guide, *Audits of Government Contractors* (New York: American Institute of Certified Public Accountants, 1975), pp. 3-4

3. *Cost-plus-fixed-fee contract*—A contract under which the contractor is reimbursed for costs plus the provision for a fixed fee.
4. *Cost-plus-award-fee contract*—A contract under which the contractor is reimbursed for costs plus a fee consisting of two parts: (a) a fixed amount which does not vary with performance and (b) an award amount based on performance in areas such as quality, timeliness, ingenuity, and cost-effectiveness. The amount of award fee is based upon a subjective evaluation by the government of the contractor's performance judged in light of criteria set forth in the contract.
5. *Cost-plus-incentive-fee contract (Incentive based on cost)*—A contract under which the contractor is reimbursed for costs plus a fee which is adjusted by formula in accordance with the relationship which total allowable costs bear to target cost. At the outset there is negotiated a target cost, a target fee, a minimum and maximum fee, and the adjustment formula.
6. *Cost-plus-incentive-fee contract (Incentive based on performance)*—A contract under which a contractor is reimbursed for costs plus an incentive to surpass stated performance targets by providing for increases in the fee to the extent that such targets are surpassed and for decreases to the extent that such targets are not met.²

Unit-Price Contracts

Unit-price contracts are contracts under which the contractor is paid a specified amount for every unit of work performed. A unit-price contract is essentially a fixed-price contract with the only variable being units of work performed. Variations in unit-price contracts include the same type of variations as fixed-price contracts. A unit-price contract is normally awarded on the basis of a total price that is the sum of the product of the specified units and unit prices. The method of determining total contract price may give rise to unbalanced unit prices because units to be delivered early in the contract may be assigned higher unit prices than those to be delivered as the work under the contract progresses.

²AICPA Industry Audit Guide, *Audits of Government Contractors*, pp. 4-6

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APPENDIX C

**Summary of Disclosure Recommendations
in Statement of Position**

<i>SOP Par.</i>	<i>Nature of Disclosure</i>
.21	Accounting policy—methods of reporting revenue
.45	Method or methods of measuring extent of progress toward completion
.52	Criteria for determining substantial completion
.65–.67	Information on revenue and costs arising from claims
.84	Effects of changes in estimates on contracts
.90–.91	Effects of accounting changes to conform to SOP

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➤➤➤ *The next page is 18,921.* ←➤➤➤

Section 10,340***Statement of Position 81-2
Reporting Practices Concerning
Hospital-Related Organizations***

August 1, 1981

**[Proposal to the Financial Accounting Standards Board to Amend
AICPA Industry Audit Guide, Hospital Audit Guide.]****NOTE**

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA committees, subcommittees, or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA committee, subcommittee, or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the committee, subcommittee, or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee, subcommittee, or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the committee, subcommittee, or task force believes would be in the public interest.

.01 In recent years there has been an increasing trend toward the creation of separate organizations, frequently referred to as foundations, to raise and hold certain funds for hospitals.

.02 Those organizations appear to have been created to broaden the philanthropic base of hospitals and to preserve discretionary funds to support desired programs. There is a growing fear that governmental programs and controls will require the expenditure of such funds to subsidize nondiscretionary services. Organizers of separate fund-raising entities hope that exposure of the funds to such threats may be avoided, or at least lessened, by the use of separate organizations.

.03 Some people believe that the financial statements of the separate organizations should not be combined with those of the related hospitals because combining them would result in a requirement to use contributed discretionary funds to defray a portion of the costs of care for patients who are covered by programs such as Medicare, Medicaid, and Blue Cross. Others share that concern but believe that it should be dealt with independently of accounting considerations and that accounting and reporting should be determined without reference to those potential effects.

.04 There is also concern that, if the form of the combination reflects the unrestricted resources of the related organization as unrestricted resources of the hospital, the difference in the availability of the related organization's resources because of its separate legal status would not be clearly disclosed.

.05 The AICPA's *Hospital Audit Guide* presently calls for combined financial reporting for related organizations "if significant resources or operations of a hospital are handled by such organizations . . . [and they] are under control of (or common control with) hospitals. . . ." However, the guide does not give sufficient guidance about what constitutes "control" or "hospital resources." As a consequence, a variety of reporting practices are being followed, and the financial statements of some related organizations are combined with those of hospitals while the financial statements of other organizations in similar circumstances are not. The related facts and circumstances sometimes are disclosed and sometimes are not.

.06 Because of the variety of current reporting practices, the subcommittee on health care matters believes that the *Hospital Audit Guide* should be clarified in this area.

Subcommittee's Conclusions

.07 The subcommittee on health care matters believes that the section of the *Hospital Audit Guide*, 3d ed. (1980), under "Other Related Organizations" (pages 11 and 12) should be superseded by the following paragraphs.

.08 Foundations, auxiliaries, guilds, and similar organizations frequently assist and, in many instances, are related to hospitals. Accounting Research Bulletin no. 51, *Consolidated Financial Statements*, provides guidance on whether the financial statements of related organizations should be consolidated or combined. Page 3 of the *Hospital Audit Guide* indicates the applicability of Accounting Research Bulletins to hospitals.

.09 Not-for-profit hospitals may be related to one or more separate not-for-profit organizations. For purposes of this statement of position, a separate organization is considered to be related to a hospital¹ if

- a. The hospital controls the separate organization through contracts or other legal documents that provide the hospital with the authority to direct the separate organization's activities, management, and policies; *or*
- b. The hospital is for all practical purposes the sole beneficiary of the organization. The hospital should be considered the organization's sole beneficiary if any one of the three following circumstances exist:
 1. The organization has solicited funds in the name of the hospital, and with the expressed or implied approval of the hospital, and substantially all the funds solicited by the organization were intended by the contributor, or were otherwise required, to be transferred to the hospital or used at its discretion or direction.
 2. The hospital has transferred some of its resources to the organization, and substantially all of the organization's resources are held for the benefit of the hospital.

¹This paragraph presents criteria for determining whether such an organization is a hospital-related organization for the purposes of this statement of position SAS No 6, *Related Party Transactions*, discusses the auditor's responsibilities concerning related parties in general

3. The hospital has assigned certain of its functions (such as the operation of a dormitory) to the organization, which is operating primarily for the benefit of the hospital.

.10 If the condition described in subparagraph .09a and at least one of the conditions described in subparagraph .09b are satisfied, and if the financial statements of the hospital and the related organizations are not consolidated or combined in accordance with paragraph .08, then the hospital's financial statements should disclose information concerning the related organizations. The hospital should present summarized information about the assets, liabilities, results of operations, and changes in fund balances of the related organizations in the notes to the hospital's financial statements and should clearly describe the nature of the relationships between the hospital and the related organizations. (Appendix A illustrates this disclosure.) When a related organization makes its assets available to the hospital, the hospital should account for them in accordance with the terms and conditions prescribed by the related organization.

.11 There may be instances in which the items presented in the financial statements of the related organization are not consolidated, combined, or disclosed in accordance with the requirements of paragraph .10 because they do not meet the conditions described in the preceding paragraphs. If a related organization holds material amounts of funds that have been designated for the benefit of the hospital, or if there have been material transactions between the hospital and the related organization, the hospital's financial statements should disclose the existence and nature of the relationship between the hospital and the related organization. Further, if there have been material transactions between the hospital and the related organization during the periods covered by the hospital's financial statements, the following should also be disclosed:

- a. A description of the transactions, summarized if appropriate, for the period reported on, including amounts, if any, and any other information deemed necessary to an understanding of the effects on the hospital's financial statements.
- b. The dollar volume of transactions and the effects of any change in the terms from the preceding period.
- c. Amounts due from or to the related organization, and, if not otherwise apparent, the terms and manner of settlement.

.12 Appendix B illustrates the foregoing disclosures for a not-for-profit hospital that, during the year, received substantial amounts of contributions from a not-for-profit community health fund-raising organization that is controlled by the hospital but that also raises funds for other health-related organizations in the community. Similar information would also be disclosed in situations in which the hospital does not control the separate organization but is its sole beneficiary, as described in subparagraph .09b, and there have been material transactions during the year between the hospital and the separate organization.

Transition

.13 This statement of position should be applied in financial statements for fiscal years beginning on or after July 1, 1981, although earlier application is encouraged. Accounting changes adopted to apply the recommendations of this statement of position should be made retroactively by restating the financial statements of prior periods.

.14

APPENDIX A

Note — Sample Hospital Foundation

Note: Appendix A illustrates the disclosure by a not-for-profit hospital that is considered to be related to a separate not-for-profit organization because the hospital controls it and is deemed to be its sole beneficiary, as described in paragraph .09 of the SOP.

Sample Hospital Foundation (the foundation) was established to raise funds to support the operation of Sample Hospital. The foundation's bylaws provide that all funds raised, except for funds required for operation of the foundation, be distributed to or be held for the benefit of the hospital. The foundation's bylaws also provide the hospital with the authority to direct its activities, management, and policies. The foundation's general funds, which represent the foundation's unrestricted resources, are distributed to the hospital in amounts and in periods determined by the foundation's board of trustees, who may also restrict the use of general funds for hospital plant replacement or expansion or other specific purposes. Plant replacement and expansion funds, specific-purpose funds, and assets obtained from income from endowment funds of the foundation are distributed to

the hospital as required to comply with the purposes specified by donors. A summary of the foundation's assets, liabilities and fund balances, results of operations, and changes in fund balances follows.

	<u>19X1</u>	<u>19X0</u>
	<i>(in thousands)</i>	
Assets	<u>\$11,118</u>	<u>\$10,265</u>
Liabilities ⁽¹⁾	<u>\$ 1,046</u>	<u>\$ 1,025</u>
Fund balances		
Unrestricted	3,525	3,230
Restricted	<u>6,547</u>	<u>6,010</u>
Total fund balances	<u>10,072</u>	<u>9,240</u>
Total liabilities and fund balances	<u>\$11,118</u>	<u>\$10,265</u>

1 Includes \$1 million payable at the end of each year to Sample Hospital. These amounts were paid after the end of each year

	<u>19X1</u>	<u>19X0</u>
	<i>(in thousands)</i>	
Support and revenue	<u>\$ 4,867</u>	<u>\$ 4,240</u>
Expenses		
Distributions to Sample Hospital ⁽²⁾	4,154	3,112
Other	<u>228</u>	<u>320</u>
Total expenses	<u>4,382</u>	<u>3,432</u>
Excess of support and revenue over expenses	485	808
Other changes in fund balances	347	112
Fund balance, beginning of year	<u>9,240</u>	<u>8,320</u>
Fund balance, end of year	<u>\$10,072</u>	<u>\$ 9,240</u>

2 The distributions by the foundation to Sample Hospital are included in the hospital's financial statements as follows

	<u>19X1</u>	<u>19X0</u>
	<i>(in thousands)</i>	
Unrestricted grants and contributions	\$1,404	\$ 912
Restricted grants for specific purposes	250	200
Plant replacement and expansion	<u>2,500</u>	<u>2,000</u>
	<u>\$4,154</u>	<u>\$3,112</u>

.15

APPENDIX B

Note — Related-Party Transactions

Note. Appendix B illustrates the disclosure by a not-for-profit hospital that is considered to be related to a separate not-for-profit organization because it controls the separate organization but is not its sole beneficiary, as described in paragraph .09 of the SOP. There were also material transactions between the hospital and the related organization.

Because of the existence of common trustees and other factors, ABC Hospital controls Community Health Foundation (the foundation). The foundation is authorized by ABC Hospital to solicit contributions on its behalf. In its general appeal for contributions to support the community's providers of health care services, the foundation also solicits contributions for certain other health care institutions. In the absence of donor restrictions, the foundation has discretionary control over the amounts to be distributed to the providers of health care services, the timing of such distributions, and the purposes for which such funds are to be used.

The contributions made by the foundation to the hospital during the year ended December 31, 19X1 and 19X0, are included in the hospital's financial statements as follows.

	<u>19X1</u>	<u>19X0</u>
Unrestricted contributions	\$150,000	\$150,000
Restricted contributions for		
Specific purposes	35,000	25,000
Plant replacement and expansion purposes	25,000	50,000
Endowment purposes	50,000	150,000

.16

APPENDIX C

Summary of Requirements of the Hospital

<u>Circumstances</u>	<u>Requirements</u>
1. The hospital is related to a separate organization and meets the criteria stated in ARB no. 51.	Consolidate or combine in accordance with ARB no. 51.
2. The hospital does not meet the criteria stated in ARB no. 51 but controls <i>and</i> is the sole beneficiary of the related organization's activities.	In a note to the financial statements, disclose summarized financial data of the related organization, such as total assets, total liabilities, changes in fund balances, total revenue, total expenses, and amount of distributions to the hospital; and disclose the nature of the relationship between the hospital and the related organization.
3. Neither of the above is present, but the related organization holds significant amounts of funds designated for the hospital.	Disclose the existence and nature of the relationship.
4. There have been material transactions between the hospital and the related organization. (This could be present in any of the above circumstances.)	In the notes to the financial statements, (a) disclose the existence and nature of the relationship and (b) describe and quantify the transactions.

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The subcommittee gratefully acknowledges the contributions made to the development of this statement of position by former members of the subcommittee:

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»»» → *The next page is 18,931.* ← «««

Section 10,350**Statement of Position 82-1
Accounting and Financial
Reporting for Personal
Financial Statements**

October 1, 1982

**[Amendment to AICPA Industry Audit Guide Audits
of Personal Financial Statements.]****NOTE**

This statement of position significantly amends the recommendations on accounting principles in the AICPA Industry Audit Guide, *Audits of Personal Financial Statements* (1968), for personal financial statements dated June 30, 1983, or after.

Statements of position of the accounting standards division present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the Institute's Code of Professional Ethics. However, Statement on Auditing Standards 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by Statement on Auditing Standards 43, *Omnibus Statement on Auditing Standards*, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be aware that they may be called upon to justify departures from the recommendations in this statement of position if their work is challenged.

Introduction

.01 This statement of position deals with the preparation and presentation of personal financial statements, that is, financial statements of individuals or groups of related individuals (families). Personal financial statements are prepared for individuals either

to formally organize and plan their financial affairs in general or for specific purposes, such as obtaining of credit, income tax planning, retirement planning, gift and estate planning, or public disclosure of their financial affairs. Users of personal financial statements rely on them in determining whether to grant credit, in assessing the financial activities of individuals, in assessing the financial affairs of public officials and candidates for public office, and for similar purposes.

.02 The 1968 AICPA Industry Audit Guide, *Audits of Personal Financial Statements*, supported historical cost as the primary basis of measurement for personal financial statements and recommended the presentation of estimated current values as additional information. The preface to that guide stated that “generally accepted accounting principles and auditing standards developed for commercial enterprises are applicable in general to personal financial statements.” However, the increasing use of personal financial statements and experience with the use of the guide suggested the need to reassess those conclusions in light of the purposes for which personal financial statements are prepared, the users to whom they are directed, and the ways in which they are used. This statement of position is the result of that reassessment, it supersedes the accounting provisions of the 1968 AICPA Industry Audit Guide, *Audits of Personal Financial Statements*, in accordance with the transition and effective date set forth in paragraph .33 of this statement of position.

Basis of Presentation of Personal Financial Statements

.03 The primary focus of personal financial statements is a person’s assets and liabilities, and the primary users of personal financial statements normally consider estimated current value information to be more relevant for their decisions than historical cost information. Lenders require estimated current value information to assess collateral, and most personal loan applications require estimated current value information. Estimated current values are required for estate, gift, and income tax planning, and estimated current value information about assets is often required in federal and state filings of candidates for public office.

.04 The accounting standards division therefore believes personal financial statements should present assets at their estimated current values and liabilities at their estimated current amounts at the date of the financial statements. Paragraph .12 of this statement of position defines estimated current values of assets. Paragraph .27 defines estimated current amounts of liabilities. This statement of position explains how the estimated current values of assets and the estimated current amounts of liabilities should be determined and applied in the preparation and presentation of personal financial statements.¹

Presentation of Personal Financial Statements

The Reporting Entity

.05 Personal financial statements may be prepared for an individual, a husband and wife, or a family.

The Form of the Statements

.06 Personal financial statements consist of—

- a. *A statement of financial condition.* This is the basic personal financial statement. It presents the estimated current values of assets, the estimated current amounts of liabilities, estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases, and net worth at a specified date. The term *net worth* should be used in the statement to designate the difference between total assets and total liabilities, after deducting estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases.
- b. *A statement of changes in net worth.* This statement presents the major sources of increases and decreases in net worth. It should present the major sources of increases in net worth: income, increases in the estimated current values of assets,

¹The division recognizes that users of personal financial statements may sometimes request certain historical cost information. This statement of position does not prohibit supplemental presentation of such information.

decreases in the estimated current amounts of liabilities, and decreases in estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. It should present the major sources of decreases in net worth: expenses, decreases in the estimated current values of assets, increases in the estimated current amounts of liabilities, and increases in estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. One statement combining income and other changes is desirable because of the mix of business and personal items in personal financial statements. The presentation of a statement of changes in net worth is optional.

- c. *Comparative financial statements.* The presentation of comparative financial statements of the current period and one or more prior periods may sometimes be desirable. Such a presentation is more informative than the presentation of financial statements for only one period. The presentation of comparative financial statements is optional.

Illustrative financial statements are presented in Appendix A to this statement of position.

The Methods of Presentation

.07 Assets and liabilities and changes in them should be recognized on the accrual basis, not on the cash basis.

.08 The most useful and readily understood presentation of assets and liabilities in personal financial statements is by order of liquidity and maturity, without classification as current and non-current, since the concept of working capital applied to business enterprises is inappropriate for personal financial statements.

.09 If personal financial statements are prepared for one of a group of joint owners of assets, the statements should include only the person's interest as a beneficial owner, as determined under the property laws of the state having jurisdiction. If property is held in joint tenancy, as community property, or through a similar joint ownership arrangement, the legal status of the separate equities of the parties may not be evident. In that case, the person may require legal advice to determine whether an interest in the

property should be included among the person's assets and, if so, the proper allocation of the equity in the property under the applicable state laws.

.10 Business interests that constitute a large part of a person's total assets should be shown separately from other investments. The estimated current value of an investment in a separate entity, such as a closely held corporation, a partnership, or a sole proprietorship, should be shown in one amount as an investment if the entity is marketable as a going concern. Assets and liabilities of the separate entity should not be combined with similar personal items.

.11 The estimated current values of assets and the estimated current amounts of liabilities of limited business activities not conducted in a separate business entity, such as an investment in real estate and a related mortgage, should be presented as separate amounts, particularly if a large portion of the liabilities may be satisfied with funds from sources unrelated to the investment.

Guidelines for Determining the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities

General

.12 Personal financial statements should present assets at their estimated current values and liabilities at their estimated current amounts. The estimated current value of an asset in personal financial statements is the amount at which the item could be exchanged between a buyer and seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell. Costs of disposal, such as commissions, if material, should be considered in determining estimated current values.² The division recognizes that the estimated current values of some assets may be difficult to determine and the cost of obtaining estimated current values of some assets directly may exceed the benefits of doing so; therefore, the division recommends that judgment be exercised in determining estimated current values.

²Paragraph .27 defines the estimated current amount of a liability

.13 Recent transactions involving similar assets and liabilities in similar circumstances ordinarily provide a satisfactory basis for determining the estimated current value of an asset and the estimated current amount of a liability. If recent sales information is unavailable, other methods that may be used include the capitalization of past or prospective earnings, the use of liquidation values, the adjustment of historical cost based on changes in a specific price index, the use of appraisals, or the use of the discounted amounts of projected cash receipts and payments.

.14 In determining the estimated current values of some assets (for example, works of art, jewelry, restricted securities, investments in closely held businesses, and real estate), the person may need to consult a specialist.

.15 The methods used to determine the estimated current values of assets and the estimated current amounts of liabilities should be followed consistently from period to period unless the facts and circumstances dictate a change to different methods.

Receivables

.16 Personal financial statements should present receivables at the discounted amounts of cash the person estimates will be collected, using appropriate interest rates at the date of the financial statements.

Marketable Securities

.17 Marketable securities include both debt and equity securities for which market quotations are available. The estimated current values of such securities are their quoted market prices. The estimated current values of securities traded on securities exchanges are the closing prices of the securities on the date of the financial statements (valuation date) if the securities were traded on that date. If the securities were not traded on that date but published bid and asked prices are available, the estimated current values of the securities should be within the range of those prices.

.18 For securities traded in the over-the-counter market, quotations of bid and asked prices are available from several

sources, including the financial press, various quotation publications and financial reporting services, and individual broker-dealers. For those securities, the mean of the bid prices, of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoting the securities may be used as the estimated current values.

.19 An investor may hold a large block of the equity securities of a company. A large block of stock might not be salable at the price at which a small number of shares were recently sold or quoted. Further, a large minority interest may be difficult to sell despite isolated sales of a small number of shares. However, a controlling interest may be proportionately more valuable than minority interests that were sold. Consideration of those factors may require adjustments to the price at which the security recently sold. Moreover, restrictions on the transfer of a security may also suggest the need to adjust the recent market price in determining the estimated current value.³

Options

.20 If published prices of options are unavailable, their estimated current values should be determined on the basis of the values of the assets subject to option, considering such factors as the exercise prices and length of the option periods.

Investment in Life Insurance

.21 The estimated current value of an investment in life insurance is the cash value of the policy less the amount of any loans against it. The face amount of life insurance the individuals own should be disclosed.

Investments in Closely Held Businesses

.22 The division recognizes that the estimated current values of investments in closely held businesses usually are difficult to determine. The problems relate to investments in closely held businesses in any form, including sole proprietorships, general and limited partnerships, and corporations. As previously stated, only the net investment in a business enterprise (not its assets and

³For further discussion on valuing marketable securities, see the AICPA Industry Audit Guide, *Audits of Investment Companies* (New York: AICPA, 1973) pp. 15-17.

liabilities) should be presented in the statement of financial condition. The net investment should be presented at its estimated current value at the date of the financial statement. Since there is usually no established ready market for such an investment, judgment should be exercised in determining the estimated current value of the investment.

.23 There is no one generally accepted procedure for determining the estimated current value of an investment in a closely held business. Several procedures or combinations of procedures may be used to determine the estimated current value of a closely held business, including a multiple of earnings, liquidation value, reproduction value, appraisals, discounted amounts of projected cash receipts and payments, or adjustments of book value or cost of the person's share of the equity of the business.⁴ The owner of an interest in a closely held business may have entered into a buy-sell agreement that specifies the amount (or the basis of determining the amount) to be received in the event of withdrawal, retirement, or sale. If such an agreement exists, it should be considered, but it does not necessarily determine estimated current value. Whatever procedure is used, the objective should be to approximate the amount at which the investment could be exchanged between a buyer and a seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell.

Real Estate (Including Leaseholds)

.24 Investments in real estate (including leaseholds) should be presented in personal financial statements at their estimated current values. Information that may be used in determining their estimated current values includes—

- a. Sales of similar property in similar circumstances.
- b. The discounted amounts of projected cash receipts and payments relating to the property or the net realizable value of the property, based on planned courses of action, including leaseholds whose current rental value exceeds the rent in the lease.

⁴The book value or cost of a person's share of the equity of a business adjusted for appraisals of specific assets such as real estate or equipment, is sometimes used as the estimated current value.

- c. Appraisals based on estimates of selling prices and selling costs obtained from independent real estate agents or brokers familiar with similar properties in similar locations.
- d. Appraisals used to obtain financing.
- e. Assessed value for property taxes, including consideration of the basis for such assessments and their relationship to market values in the area.

Intangible Assets

.25 Intangible assets should be presented at the discounted amounts of projected cash receipts and payments arising from the planned use or sale of the assets if both the amounts and timing can be reasonably estimated. For example, a record of receipts under a royalty agreement may provide sufficient information to determine its estimated current value. The cost of a purchased intangible should be used if no other information is available.

Future Interests and Similar Assets

.26 Nonforfeitable rights to receive future sums that have all the following characteristics should be presented as assets at their discounted amounts:

- The rights are for fixed or determinable amounts.
- The rights are not contingent on the holder's life expectancy or the occurrence of a particular event, such as disability or death.
- The rights do not require future performance of service by the holder

Nonforfeitable rights that may have those characteristics include—

- Guaranteed minimum portions of pensions.
- Vested interests in pension or profit sharing plans.
- Deferred compensation contracts.
- Beneficial interests in trusts.
- Remainder interests in property subject to life estates.
- Annuities.
- Fixed amounts of alimony for a definite future period.

Payables and Other Liabilities

.27 Personal financial statements should present payables and other liabilities at the discounted amounts of cash to be paid. The discount rate should be the rate implicit in the transaction in which the debt was incurred. If, however, the debtor is able to discharge the debt currently at a lower amount, the debt should be presented at the lower amount.⁵

Noncancellable Commitments

.28 Noncancellable commitments to pay future sums that have all the following characteristics should be presented as liabilities at their discounted amounts:

- The commitments are for fixed or determinable amounts.
- The commitments are not contingent on others' life expectancies or the occurrence of a particular event, such as disability or death.
- The commitments do not require future performance of service by others.

Noncancellable commitments that may have those characteristics include fixed amounts of alimony for a definite future period and charitable pledges.

Income Taxes Payable

.29 The liability for income taxes payable should include unpaid income taxes for completed tax years and an estimated amount for income taxes accrued for the elapsed portion of the current tax year to the date of the financial statements. That estimate should be based on the relationship of taxable income earned to date to total estimated taxable income for the year, net of taxes withheld or paid with estimated income tax returns.

⁵For a further discussion of the setting of a discount rate for payables and other liabilities, see APB Opinion 21, *Interest on Receivables and Payables* paragraph 13

Estimated Income Taxes on the Differences Between the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities and Their Tax Bases

.30 A provision should be made for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases, including consideration of negative tax bases of tax shelters, if any. The provision should be computed as if the estimated current values of all assets had been realized and the estimated current amounts of all liabilities had been liquidated on the statement date, using applicable income tax laws and regulations, considering recapture provisions and available carryovers. The estimated income taxes should be presented between liabilities and net worth in the statement of financial condition. The methods and assumptions used to compute the estimated income taxes should be fully disclosed. Appendix B to this statement of position illustrates how to compute the provision.

Financial Statement Disclosures

.31 Personal financial statements should include sufficient disclosures to make the statements adequately informative. The disclosures may be made in the body of the financial statements or in the notes. The following enumeration is intended not to be all-inclusive but simply indicative of the nature and type of information that ordinarily should be disclosed:

- a. A clear indication of the individuals covered by the financial statements
- b. That assets are presented at their estimated current values and liabilities are presented at their estimated current amounts
- c. The methods used in determining the estimated current values of major assets and the estimated current amounts of major liabilities or major categories of assets and liabilities, since several methods are available, and changes in methods from one period to the next
- d. If assets held jointly by the person and by others are included in the statements, the nature of the joint ownership
- e. If the person's investment portfolio is material in relation to his or her other assets and is concentrated in one or a few

companies or industries, the names of the companies or industries and the estimated current values of the securities

- f. If the person has a material investment in a closely held business, at least the following:
 - The name of the company and the person's percentage of ownership
 - The nature of the business
 - Summarized financial information about assets, liabilities, and results of operations for the most recent year based on the financial statements of the business, including information about the basis of presentation (for example, generally accepted accounting principles, income tax basis, or cash basis) and any significant loss contingencies
- g. Descriptions of intangible assets and their estimated useful lives
- h. The face amount of life insurance the individuals own
- i. Nonforfeitable rights that do not have the characteristics discussed in paragraph .26, for example, pensions based on life expectancy
- j. The following tax information:
 - The methods and assumptions used to compute the estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases and a statement that the provision will probably differ from the amounts of income taxes that might eventually be paid because those amounts are determined by the timing and the method of disposal, realization, or liquidation and the tax laws and regulations in effect at the time of disposal, realization, or liquidation
 - Unused operating loss and capital loss carryforwards
 - Other unused deductions and credits, with their expiration periods, if applicable
 - The differences between the estimated current values of major assets and the estimated current amounts of major liabilities or categories of assets and liabilities and their tax bases
- k. Maturities, interest rates, collateral, and other pertinent details relating to receivables and debt

- l.* Noncancellable commitments that do not have the characteristics discussed in paragraph.28, for example, operating leases

.32 Generally accepted accounting principles other than those discussed in this statement of position may apply to personal financial statements. For example, FASB Statement 5, *Accounting for Contingencies*, and related amendments and interpretations, provide guidance on accounting for contingencies, and FASB Statement 57, *Related Party Disclosures*, provides guidance on related-party disclosures.

Transition and Effective Date

.33 The accounting standards division recommends that the provisions of this statement of position should apply to personal financial statements dated June 30, 1983, or after. Comparative statements of prior periods should be restated to comply with the provisions of this statement of position.

.34

APPENDIX A

Illustrative Financial Statements

James and Jane Person
 Statements of Financial Condition
 December 31, 19X3 and 19X2

	<i>December 31,</i>	
	<u>19X3</u>	<u>19X2</u>
Assets		
Cash	\$ 3,700	\$ 15,600
Bonus receivable	20,000	10,000
Investments		
Marketable securities (Note 2)	160,500	140,700
Stock options (Note 3)	28,000	24,000
Kenbruce Associates (Note 4)	48,000	42,000
Davekar Company, Inc. (Note 5)	550,000	475,000
Vested interest in deferred profit sharing plan	111,400	98,900
Remainder interest in testamentary trust (Note 6)	171,900	128,800
Cash value of life insurance (\$43,600 and \$42,900), less loans payable to insurance companies (\$38,100 and \$37,700) (Note 7)	5,500	5,200
Residence (Note 8)	190,000	180,000
Personal effects (excluding jewelry) (Note 9)	55,000	50,000
Jewelry (Note 9)	40,000	36,500
	<u>\$ 1,384,000</u>	<u>\$ 1,206,700</u>

	<i>December 31,</i>	
	<u>19X3</u>	<u>19X2</u>
Liabilities		
Income taxes—current year balance	\$ 8,800	\$ 400
Demand 10.5% note payable to bank	25,000	26,000
Mortgage payable (Note 10)	98,200	99,000
Contingent liabilities (Note 11)		
	<u>132,000</u>	<u>125,400</u>
Estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases (Note 12)	239,000	160,000
Net worth	<u>1,013,000</u>	<u>921,300</u>
	<u>\$ 1,384,000</u>	<u>\$ 1,206,700</u>

The notes to financial statements are an integral part of these statements.

James and Jane Person
 Statements of Changes in Net Worth
 For the Years Ended December 31, 19X3 and 19X2

	<i>Year ended December 31,</i>	
	<u>19X3</u>	<u>19X2</u>
Realized increases in net worth		
Salary and bonus	\$ 95,000	\$ 85,000
Dividends and interest income	2,300	1,800
Distribution from limited partnership	5,000	4,000
Gains on sales of marketable securities	1,000	500
	<u>103,300</u>	<u>91,300</u>
Realized decreases in net worth		
Income taxes	26,000	22,000
Interest expense	13,000	14,000
Real estate taxes	4,000	3,000
Personal expenditures	36,700	32,500
	<u>79,700</u>	<u>71,500</u>
Net realized increase in net worth	<u>23,600</u>	<u>19,800</u>

	<i>Year ended December 31,</i>	
	<u>19X3</u>	<u>19X2</u>
Unrealized increases in net worth		
Marketable securities (net of realized gains on securities sold)	3,000	500
Stock options	4,000	500
Davekar Company, Inc.	75,000	25,000
Kenbruce Associates	6,000	
Deferred profit sharing plan	12,500	9,500
Remainder interest in testamentary trust	43,100	25,000
Jewelry	3,500	
	<u>147,100</u>	<u>60,500</u>
Unrealized decrease in net worth		
Estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases	79,000	22,000
Net unrealized increase in net worth	<u>68,100</u>	<u>38,500</u>
Net increase in net worth	91,700	58,300
Net worth at the beginning of year	<u>921,300</u>	<u>863,000</u>
Net worth at the end of year	<u><u>\$ 1,013,000</u></u>	<u><u>\$ 921,300</u></u>

The notes to financial statements are an integral part of these statements.

James and Jane Person
Notes to Financial Statements

Note 1. The accompanying financial statements include the assets and liabilities of James and Jane Person. Assets are stated at their estimated current values, and liabilities at their estimated current amounts.

Note 2. The estimated current values of marketable securities are either (a) their quoted closing prices or (b) for securities not traded on the financial statement date, amounts that fall within the range of quoted bid and asked prices.

Marketable securities consist of the following:

	<i>December 31, 19X3</i>		<i>December 31, 19X2</i>	
	<i>Number of shares or bonds</i>	<i>Estimated current values</i>	<i>Number of shares or bonds</i>	<i>Estimated current values</i>
<i>Stocks</i>				
Jaiven Jewels, Inc.	1,500	\$ 98,813		
McRae Motors, Ltd.	800	11,000	600	\$ 4,750
Parker Sisters, Inc.	400	13,875	200	5,200
Rosenfield Rug Co.			1,200	96,000
Rubin Paint Com- pany	300	9,750	100	2,875
Weiss Potato Chips, Inc.	200	20,337	300	25,075
		153,775		133,900
<i>Bonds</i>				
Jackson Van Lines, Ltd. (12% due 7/1/X9)	5	5,225	5	5,100
United Garvey, Inc. (7% due 11/15/X6)	2	1,500	2	1,700
		6,725		6,800
		\$160,500		\$140,700

Note 3. Jane Person owns options to acquire 4,000 shares of stock of Winner Corp. at an option price of \$5 per share. The option expires on June 30, 19X5. The estimated current value is its published selling price

Note 4. The investment in Kenbruce Associates is an 8% interest in a real estate limited partnership. The estimated current value is determined by the projected annual cash receipts and payments capitalized at a 12% rate

Note 5. James Person owns 50% of the common stock of Davekar Company, Inc., a retail mail order business. The estimated current value of the investment is determined by the provisions of a shareholders' agreement, which restricts the sale of the stock and, under certain conditions, requires the company to repurchase the stock based on a price equal to the book value of the net assets plus an agreed amount for goodwill. At December 31, 19X3, the agreed amount for goodwill was \$112,500, and at December 31, 19X2, it was \$100,000.

A condensed balance sheet of Davekar Company, Inc., prepared in conformity with generally accepted accounting principles, is summarized below:

	<i>December 31,</i>	
	<u>19X3</u>	<u>19X2</u>
Current assets	\$3,147,000	\$2,975,000
Plant, property, and equipment—net	165,000	145,000
Other assets	120,000	110,000
Total assets	<u>3,432,000</u>	<u>3,230,000</u>
Current liabilities	2,157,000	2,030,000
Long-term liabilities	400,000	450,000
Total liabilities	<u>2,557,000</u>	<u>2,480,000</u>
Equity	<u>\$ 875,000</u>	<u>\$ 750,000</u>

The sales and net income for 19X3 were \$10,500,000 and \$125,000 and for 19X2 were \$9,700,000 and \$80,000.

Note 6. Jane Person is the beneficiary of a remainder interest in a testamentary trust under the will of the late Joseph Jones. The amount included in the accompanying statements is her remainder interest in the estimated current value of the trust assets, discounted at 10%.

Note 7. At December 31, 19X3 and 19X2, James Person owned a \$300,000 whole life insurance policy

Note 8. The estimated current value of the residence is its purchase price plus the cost of improvements. The residence was purchased in December 19X1, and improvements were made in 19X2 and 19X3

Note 9. The estimated current values of personal effects and jewelry are the appraised values of those assets, determined by an independent appraiser for insurance purposes

Note 10. The mortgage (collateralized by the residence) is payable in monthly installments of \$815 a month, including interest at 10% a year through 20Y8

Note 11. James Person has guaranteed the payment of loans of Davekar Company, Inc., under a \$500,000 line of credit. The loan balance was \$300,000 at December 31, 19X3, and \$400,000 at December 31, 19X2.

Note 12. The estimated current amounts of liabilities at December 31, 19X3, and December 31, 19X2, equaled their tax bases. Estimated income taxes have been provided on the excess of the estimated current values of assets over their tax bases as if the estimated current values of the assets had been realized on the statement date, using applicable tax laws and regulations. The provision will probably differ from the amounts of income taxes that eventually might be paid because those amounts are determined by the timing and the method of disposal or realization and the tax laws and regulations in effect at the time of disposal or realization.

The estimated current values of assets exceeded their tax bases by \$850,000 at December 31, 19X3, and by \$770,300 at December 31, 19X2. The excess of estimated current values of major assets over their tax bases are—

	<i>December 31,</i>	
	<u>19X3</u>	<u>19X2</u>
Investment in Davekar Company, Inc	\$430,500	\$355,500
Vested interest in deferred profit sharing plan	111,400	98,900
Investment in marketable securities	104,100	100,000
Remainder interest in testamentary trust	97,000	53,900

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APPENDIX B

Computing the Excess of the Estimated Current Values of Assets Over Their Tax Bases and the Estimated Income Taxes on the Excess

This appendix relates to the preceding illustrative financial statements of James and Jane Person (Appendix A) and illustrates how to compute the excess of the estimated current values of assets over their tax bases and the provision for estimated income taxes on the excess.¹

The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases should be disclosed.² The provision for estimated income taxes should be presented in the statement of financial condition between liabilities and net worth.

The assumptions and the tax basis information used in computing the excess of the estimated current values of assets over their tax bases and the estimated income taxes on the excess depend on the facts, circumstances, tax laws and regulations, and assumptions that apply to the individual or individuals for whom the financial statements are prepared. The facts, circumstances, tax laws and regulations, and assumptions used in the following are illustrative only.

¹The provision for estimated income taxes should also reflect tax consequences that result from differences between the estimated current amounts of liabilities and their tax bases.

²Differences between the estimated current amounts of major liabilities or categories of liabilities and their tax bases should also be disclosed.

Statements of Position

Description	(A) Estimated current values	(B) Tax bases	Excess of (A) over (B)	Effective income tax rates	Amount of estimated income taxes	Assumptions used
Cash	\$ 3,700	\$ 3,700	—	—	—	No tax effect.
Bonus receivable	20,000	—	\$ 20,000	50%	\$ 10,000	Maximum tax rate.
Investments						
Marketable securities	160,500	56,400	104,100	36%	37,500	Weighted average of short-term and long-term capital gain rates based on composition of portfolio.
Stock options	28,000	20,000	8,000	50%	4,000	Short-term capital gain rate.
Kenbruce Associates	48,000	24,000	24,000	38%	9,100	Weighted average of short-term and long-term capital gain rates.
Davekar Company, Inc.	550,000	119,500	430,500	20%	86,100	Long-term capital gain rate.

	111,400	—	111,400	50%	55,700	Maximum tax rate.
Vested interest in deferred profit sharing plan	111,400	—	111,400	50%	55,700	Maximum tax rate.
Remainder interest in testamentary trust	171,900	74,900	97,000	26%	25,600	Weighted average of short-term and long-term capital gain rates.
Cash value of life insurance	5,500	5,500	—	—	—	No tax effect.
Residence	190,000	190,000	—	—	—	No tax effect.
Personal effects	55,000	30,000	25,000	20%	5,000	Long-term capital gain rate.
Jewelry	40,000	10,000	30,000	20%	6,000	Long-term capital gain rate.
	<u>\$1,384,000</u>	<u>\$534,000</u>	<u>\$850,000¹</u>		<u>\$239,000²</u>	

¹The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases should be disclosed

²This amount should be presented in the statement of financial condition between liabilities and net worth

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STATEMENTS OF POSITION AUDITING STANDARDS DIVISION

Introduction

Statements of Position of the Auditing Standards Division are issued to revise or clarify certain recommendations in industry-oriented audit guides or areas to which they relate. Statements of Position of the Auditing Standards Division have the same authority as that of an audit guide. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations.

➤ *The next page is 30,211.* ←

AUD Section 11,000

STATEMENTS OF POSITION

AUDITING STANDARDS

DIVISION

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Section 11,010**Revision of Form of Auditor's Report**

July 1974

NOTICE TO READERS

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA task forces may from time to time conclude that it is desirable to change a guide. A Statement of Position is used to revise or clarify certain of the recommendations in the guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA task force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the task force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the task force believes would be in the public interest.

Audits of Fire and Casualty Insurance Companies

.01 The AICPA issued in 1966 the industry audit guide, *Audits of Fire and Casualty Insurance Companies*. Chapter 9 of that guide included recommendations on the form of the auditor's report. In December 1972, the AICPA issued an industry audit guide entitled *Audits of Stock Life Insurance Companies*. The recommendations on the form of the auditor's report in that guide varied from the recommendations set forth in the fire and casualty audit guide. It is the considered judgment of the

AICPA Insurance Auditing Task Force that the portion of chapter 9 on pages 58 through 64 of the fire and casualty audit guide that deals with the form of the auditor's opinion should be revised; that portion is superseded by this Statement of Position.

.02 The preferable method of financial statement presentation to avoid the need for qualification of the auditor's report is to present the financial statements in accordance with generally accepted accounting principles.

.03 When the financial statements of fire and casualty insurance companies, used for purposes other than filing with regulatory authorities, have been prepared in conformity with regulatory practices, the independent auditor should follow the requirement of section 544.02 of SAS No. 1 that—

. . . material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or an adverse opinion on such statements. However, an adverse opinion may be accompanied by . . . [an opinion] . . . on any supplementary data furnished which are fairly presented in conformity with generally accepted accounting principles.

Independent auditors' reports which might be used are illustrated below.

Effects of Variances From Generally Accepted Accounting Principles Have Been Determined

.04 *Qualified Opinion.* When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of the variances from generally accepted accounting principles are sufficiently material to require a qualified opinion, the auditor's report might be worded as follows:

We have examined the balance sheet of X Company as of December 31, 19___, and the related statements of income, changes in surplus and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other

auditing procedures as we considered necessary in the circumstances.

The Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of _____. The effects on the accompanying financial statements of the variances between such practices and generally accepted accounting principles are described in Note X.¹

In our opinion, except for the effects of the matters referred to in the preceding paragraph, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19____, and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.05 If a statement of changes in financial position on a statutory basis is not presented, the omission should be dealt with in accordance with sections 545.04 and .05 of SAS No. 1.

.06 *Adverse Opinion.* When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of the variances from generally accepted accounting principles are so material that, in the independent auditor's judgment, a qualified opinion is not justified, an adverse opinion will be required. The adverse opinion will usually be followed by an opinion on any supplementary data presented in conformity with generally accepted accounting principles. When such data are presented separately, rather than in notes to the financial statements, the scope paragraph of the independent auditor's report should be expanded to include references to supplementary data and a second paragraph should be added referring to the variances from generally accepted accounting principles worded as in the prior example. The opinion paragraph might be worded as follows:

It is our opinion that, because of the materiality of the effects of the differences between generally accepted accounting principles and the accounting practices referred to in the preceding paragraph, the aforementioned financial statements do not present fairly the financial position of X Company at December 31, 19____, or the results of its operations or changes in its financial position for the year then ended, in

¹ If the effects of the variances are not described in a note, they should be set forth in this paragraph.

conformity with generally accepted accounting principles. It is our opinion, however, that the statements of adjustments to arrive at stockholders' (members') equity and net income present fairly stockholders' (members') equity at December 31, 19___, and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.07 When the supplementary data are included in a note to the financial statements, the last sentence of the opinion would read as follows:

It is our opinion, however, that the supplementary data included in Note X present fairly the stockholders' (members') equity at December 31, 19___, and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.08 *Variances Not Affecting All Financial Statements.* When the effects of variances from generally accepted accounting principles are material to one or more but not all of the financial statements, the auditor's report may include an unqualified opinion on the statements not so affected.

Effects of Variances From Generally Accepted Accounting Principles Have Not Been Determined

.09 When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of variances from generally accepted accounting principles have not been determined by the company, the auditor should generally be able to reasonably estimate whether such effects (a) would be immaterial so as to permit issuance of an unqualified opinion, (b) would be sufficiently material to require issuance of a qualified opinion, or (c) would be so material as to require issuance of an adverse opinion. In reporting, the auditor should then follow the appropriate form recommended above. If the auditor is not able to reasonably estimate the effects of variances, he should disclaim an opinion; his report might read as follows:

(Standard scope paragraph)

The Company presents its financial statements in conformity with the accounting practices prescribed or permitted by the

Insurance Department of the State of _____. The variances between such practices and generally accepted accounting principles are described in Note X.² The effects of such variances on the accompanying financial statements have not been determined. Therefore, we do not express any opinion on the aforementioned financial statements as to fair presentation of financial position or results of operations or changes in financial position in conformity with generally accepted accounting principles.

Opinions on Presentations in Conformity With Regulatory Practices

.10 Section 544.04 of SAS No. 1 states that—

In instances where the financial statements of regulated companies purport to be primarily presentations in accordance with prescribed accounting regulations, the independent auditor may also be asked to report upon their fair presentation in conformity with such prescribed accounting. There is no objection to the independent auditor's report containing such an opinion provided that the first standard of reporting is also observed by the issuance of a qualified or adverse opinion, as required by the circumstances.

.11 When the auditor is asked to report in this manner, he may do so by adding the following opinion to the concluding paragraph of any prior examples:

It is our opinion, however, that the aforementioned financial statements present fairly the financial position of X Company at December 31, 19____, and the results of its operations and changes in its financial position for the year then ended in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of _____, applied on a basis consistent with that of the preceding year.

Effective Date

.12 The Insurance Auditing Task Force recommends that the foregoing reporting be applied with respect to auditors' reports on financial statements of fire and casualty insurance companies for periods ending after September 30, 1974, and encourages earlier application.

² If the variances are not described in a note to the financial statements, they should be set forth in this paragraph.

Insurance Auditing Task Force

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➡ *The next page is 30,247.* ←

Section 11,020***Audits of Brokers and
Dealers in Securities***

December 1976

NOTICE TO READERS

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA subcommittees 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.

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.

.01 In 1973, the AICPA issued the industry audit guide, *Audits of Brokers and Dealers in Securities*. Recent actions by the Securities and Exchange Commission (SEC) will require the AICPA Stockbrokerage Auditing Subcommittee to revise portions of that guide. Because the SEC continually reviews its rules and issues revisions or interpretations of existing rules, independent auditors should be aware of current actions of the SEC and their effects, if any, on financial statements being examined. The purpose of this Statement of Position is to provide guidance to independent auditors during the period prior to the issuance of the revised audit guide.

Adoption of the Financial and Operational Combined Uniform Single Report

.02 The SEC recently announced the adoption of a new financial and operational reporting system for brokers and dealers in securities. The new reporting system, Financial and Operational Combined Uniform Single Report (FOCUS) is designed to eliminate duplicate reporting of information to the SEC and self-regulatory organizations. The FOCUS Report supersedes the previous Form X-17A-5¹, Form X-17A-11, the Joint Regulatory Report, Forms "M" and "Q," the income and expense reports, and various other financial and operational forms and reports required by self-regulatory organizations.² It allows brokers and dealers to file one series of reports monthly and quarterly or quarterly, depending on the type of business of the broker or dealer; the form and content of the reports to be filed are explained in SEC Release No. 34-11935.

Changes in Annual Audit Requirements

.03 The adoption of FOCUS has resulted in the elimination of the "minimum audit requirements" formerly prescribed in Form X-17A-5. The nature, timing, and extent of certain procedures previously mandated by regulation are now determined by the independent auditor based on his study and evaluation of existing internal controls and other procedures performed in accordance with generally accepted auditing standards.

.04 In reporting on the financial statements and required supplemental schedules, the independent auditor performs certain procedures on data now produced and maintained by the broker or dealer, as required by Rule 17a-4. Previously, the independent auditor was required to prepare the financial statements and supplemental schedules.

.05 The SEC has specified the statements and schedules on which the independent auditor is to report:

Financial Statements

- Statement of Financial Condition

¹ It should be noted that the new report is also designated "Form X-17A-5."

² While certain information previously required by Form X-17A-10 is now covered by Form X-17A-5, brokers and dealers must continue to file the revised Form X-17A-10 annually.

- Statement of Income (Loss)
- Statement of Changes in Financial Position
- Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietor's Capital
- Statement of Changes in Liabilities Subordinated to Claims of General Creditors

Schedules

- Computation of Net Capital Pursuant to Rule 15c3-1
- Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3
- Information Relating to the Possession or Control Requirements Pursuant to Rule 15c3-3
- A Reconciliation (or statement that one is not necessary) Pursuant to Rule 17a-5(d)(4)

The form and content of the financial statements are described in *Audits of Brokers and Dealers in Securities*.

Changes in Reporting Requirements

.06 The major changes required by FOCUS that affect the independent auditor include:

- a. The "Answers to Financial Questionnaire" and the Part III Interim Report by the independent auditor have been eliminated.
- b. Annual audited financial statements are required to be consolidated in conformity with generally accepted accounting principles. The audited Statement of Financial Condition must be in a format and on a basis consistent with the totals reported on the Statement of Financial Condition contained in Form X-17A-5, Part II or Part IIA as filed by the broker or dealer. If the Statement of Financial Condition filed on Form X-17A-5, Part II or Part IIA, is not on a consolidated basis, there may be differences between it and the statement reported on by the auditor; the SEC requires that such differences be disclosed in a note to the audited Statement of Financial Condition.
- c. The following supplemental schedules are to be included in the information required as part of the annual audit:
 1. Computation of Net Capital Pursuant to Rule 15c3-1.
 2. Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3.

3. Information Relating to the Possession or Control Requirements Pursuant to Rule 15c3-3.
4. A reconciliation pursuant to Rule 17a-5(d)(4) of the audited computations under (1) and (2) above to the unaudited computations submitted by the broker or dealer if, in the opinion of the independent auditor, the computations differ materially. The Rule provides that, "If no material differences exist, a statement so indicating shall be filed."³
- d. A Statement of Financial Condition, a Statement of Income (Loss), Statement of Changes in Financial Position, Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietor's Capital, and Statement of Changes in Liabilities Subordinated to Claims of General Creditors all should be included in the annual audited reports of all brokers and dealers, including those who were previously permitted to file only the "Answers to Financial Questionnaire."
- e. Audited financial statements must be filed within sixty (60) days of the broker's or dealer's fiscal year end, as defined in Rule 17a-5.
- f. A Supplementary Report on Internal Accounting Control must be submitted by the independent auditor. In this connection, the SEC has stated:

If, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist in the accounting system, internal accounting control, procedures for safeguarding securities, or as otherwise defined in subparagraph (g) (3), then he shall call it to the attention of the chief financial officer of the broker or dealer, who shall have a responsibility to inform the Commission and the designated examining authority by telegraphic notice within 24 hours thereafter as set forth in paragraphs (d) and (f) of Rule 17a-11. The broker or dealer shall also furnish the accountant with a copy of said notice to the Commission by telegraphic communication within said 24 hour period. If the accountant fails to receive such notice from the broker or dealer within said 24 hour period, or if he disagrees with the statements contained in the notice of the broker or dealer, the accountant shall have a responsibility to inform the Commission and the designated examining authority by report of material inadequacy within 24 hours thereafter as set forth in paragraph (f) of Rule 17a-11. Such report from

³ Securities and Exchange Commission, Securities Exchange Act of 1934, Release No. 11935, paragraph (d)(4).

the accountant shall, if the broker or dealer failed to file a notice, describe any material inadequacies found to exist. If the broker or dealer filed a notice, the accountant shall file a report detailing the aspects, if any, of the broker's or dealer's notice with which the accountant does not agree.⁴

The SEC has also stated:

A determination of a material inadequacy may, in many instances, require completed audit procedures in a particular area, appropriate review at the decision making level by management and the independent accountant, and possible consultation with counsel. While it is expected that a determination in this context involves a contemplative process, the length and complexity of the deliberations should depend on the circumstances and be completed in the shortest time possible.⁵

The report shown as Exhibit A, page 13, is appropriate only if the independent auditor has completed his examination of the financial statements. The report shown as Exhibit B, page 16, should be used if an examination has not been completed and the independent auditor disagrees with the notification made by the broker or dealer or the broker or dealer has failed to make the required notification. Consideration should be given to the possible need to consult with legal counsel and to modify the report based on the particular circumstances.

- g. The auditor must also issue a report indicating whether the assessments, for purposes of the Securities Investor Protection Corporation, were determined fairly in accordance with applicable instructions and forms, or that a claim for exclusion from membership was consistent with income reported.

Auditor's Report

.07 The auditor's standard report (Exhibit C, page 19) should include reference to the supplemental schedules discussed in paragraph 6 (c).

Objectives of an Examination

.08 The SEC has stated in the FOCUS Report the objectives of an examination:

⁴ Ibid., paragraph (h)(2).

⁵ Ibid., p. 14.

The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. The audit shall include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on the statement of financial condition, results of operations, changes in financial position, and the Computation of Net Capital Under Rule 15c3-1, the Computation for Determination of Reserve Requirements for Brokers or Dealers Under Exhibit A of Rule 15c3-3, and Information Relating to the Possession or Control Requirements Under Rule 15c3-3.⁶ The scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities and (d) the practices and procedures whose review is specified in (i), (ii), (iii) and (iv) of this paragraph would be disclosed. Additionally, as specific objectives, the audit shall include reviews of the practices and procedures followed by the client:

(i) in making the periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e);

(ii) in making the quarterly securities examinations, counts, verifications and comparisons and the recordation of differences required by Rule 17a-13;

(iii) in complying with the requirement for prompt payment for securities of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System; and

(iv) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.⁷

Extent and Timing of Auditing Procedures

.09 In determining the extent of procedures to be performed, the auditor should consider the materiality of the item in question and the possible effect of a misstatement in the financial statements and related schedules.

⁶ The forms for the Computation of Net Capital Under Rule 15c3-1 and Information Relating to the Possession or Control Requirements Under Rule 15c3-3 are contained in Securities Exchange Act of 1934, Release No. 11935.

⁷ Securities Exchange Act of 1934, Release No. 11935, paragraph (g)(1).

.10 The auditor's determination of the timing of auditing procedures is based on his evaluation of existing internal control. Only adequate internal control and appropriate consideration of the related factors discussed in the preceding paragraphs warrant the performance of certain procedures at other than the broker's or dealer's fiscal year end, as defined in Rule 17a-5. Also, Rule 17a-5 paragraph (h) (1) states:

The performance of auditing procedures involves the proper synchronization of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, securities counts, transfer verification and customer and broker confirmation in connection with verification of securities positions.

Nature of Auditing Procedures

.11 Certain procedures unique to an examination of a broker or dealer are discussed in the following paragraphs. Procedures that are similar to those for examinations of industrial and other commercial enterprises are not described in this statement. Nothing herein should be construed as limiting the independent auditor's examination or permitting the omission of any additional procedures he deems necessary in the circumstances.

.12 *Objective.* To determine, by appropriate procedures, that positions on the stock record, including securities, debt instruments, options, and commodities, are balanced and accounted for.

.13 *Procedures.* Evidential matter for stock record positions may be obtained by physical inspection, or confirmation, or by a combination of physical inspection and confirmation.

a. The following would normally be accounted for by physical inspection:

- Securities, options, and debt instruments held by the broker or dealer, including those in segregation and safe-keeping.
- Warehouse receipts.
- Spot commodities.
- Other significant amounts of liquid assets in the physical possession of the broker or dealer.

b. The following would normally be accounted for by confirmation:

- Securities, options, and commodity positions carried or held by foreign and domestic depositories, clearing corporations, and associations.

- Securities and commodity positions carried or held for the broker or dealer by other banking or brokerage houses or others.
 - Securities and commodity positions, options, and significant open contractual commitments and other money market instruments (other than uncleared “regular way” purchases and sales of securities) in accounts carried by the broker or dealer for customers, partners, officers, directors, or subordinated lenders.
 - Details of securities and commodities in trading and investment accounts of the broker or dealer (from individuals with responsibility for such accounts).
 - Details of—
 1. Securities borrowed and loaned.
 2. Securities “fail to deliver” and “fail to receive.”
 3. Material open contractual commitments with other brokers or clearing corporations and associations.
 - Significant open contractual commitments or positions in joint trading and underwriting accounts of the broker or dealer carried by others.
 - Guarantees required to satisfy significant deficits in accounts at the audit date.
- c. The following would normally be accounted for by a combination of physical inspection and confirmation:
- Positions held by agents for transfer, exchange, or redemption.
 - Positions in transit between offices of the broker or dealer.
 - Bank loan collateral.

.14

Exhibit A

Independent Auditor's Supplementary Report on Internal Accounting Control

To the Board of Directors
Standard Stockbrokerage Co., Inc.

We have examined the consolidated financial statements of Standard Stockbrokerage Co., Inc., and Subsidiaries for the period ended December 31, 19XX, and have issued our report thereon dated February 15, 19XX. As part of our examination, we made a study and evaluation of the system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards and Rule 17a-5 of the Securities and Exchange Commission. This study and evaluation included the accounting system, the procedures for safeguarding securities, and the practices and procedures followed by the client¹ (i) in making the periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e); (ii) in making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by Rule 17a-13;² (iii) in complying with the requirements for prompt payment for securities of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System;³ and (iv) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.⁴ Rule 17a-5 states that the scope of the study and evaluation should be sufficient to provide reasonable assurance that any material weakness existing at the date of our examination would be disclosed. Under generally

¹ If the broker or dealer is exempt from compliance with Rule 15c3-3, the independent auditor should include a statement indicating that the broker or dealer was in compliance with the conditions of the exemption, and that no facts came to the attention of the independent auditor indicating that such conditions had not been complied with during the period.

² If the broker or dealer does not maintain customer accounts or does not handle securities, he may not be required to undertake quarterly securities examinations, counts, verifications and comparisons and the recordation of differences required by Rule 17a-13, however, the independent auditor should indicate that he has reviewed the broker's or dealer's practices and procedures for safeguarding securities that may be received by the broker or dealer for transmittal to a clearing organization.

³ See Note 2.

⁴ See Note 2.

accepted auditing standards and Rule 17a-5, the purposes of such study and evaluation are to establish a basis for reliance thereon in determining the nature, timing, and extent of other auditing procedures necessary for expressing an opinion on the financial statements and to provide a basis for reporting material weaknesses in internal accounting control.

The objective of internal accounting control is to provide reasonable, but not absolute, assurance concerning the safeguarding of assets against loss from unauthorized use or disposition and concerning the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management. However, for the purposes of this report under Rule 17a-5, the determination of weaknesses to be reported was made without considering the practicability of corrective action by management within the framework of a cost/benefit relationship.⁵

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management either with respect to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation of the system of internal accounting control for the (period) ended December 31, 19XX, which was made for the purposes set forth in the first paragraph above and would not necessarily disclose all weaknesses in the system that may have existed during the period, disclosed (certain) (no)

⁵ This sentence makes it clear that the independent auditor is not permitted, in reporting on internal control under Rule 17a-5, to use the option indicated in Section 640.13 of SAS No. 1, which states in part, "In some cases, the auditor may conclude that for certain weaknesses corrective action by management is not practicable in the circumstances, and he may decide to exclude such weaknesses from his report."

weaknesses that we believe to be material. Such weaknesses, with an indication of (the) (any) corrective action taken or proposed, were as follows.

Accounting Firm

New York, New York
February 15, 19XX

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Exhibit B

Independent Auditor's Supplementary Report on Internal Accounting Control

(Appropriate when the broker or dealer has not made the required notification or when the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation. (See Paragraph 6f.))

September 10, 19X7

Securities and Exchange Commission
(Washington) and Appropriate
Regional Office
Designated Examining Authority

Dear Sirs:

Our most recent examination of the financial statements of Standard Stockbrokerage Co., Inc., and Subsidiaries was as of September 30, 19X6, and for the twelve-month period then ended, which we reported on under date of November 4, 19X6. We have not examined any financial statements of the company as of any date or for any period subsequent to September 30, 19X6. Although we are presently performing certain procedures as part of our examination of the financial statements of the company as of September 30, 19X7, and for the twelve-month period then ended, these procedures do not constitute all the procedures necessary in an examination made in accordance with generally accepted auditing standards or all the procedures necessary to evaluate the system of internal accounting control as required by generally accepted auditing standards and Rule 17a-5 of the Securities and Exchange Commission.

The objective of internal accounting control is to provide reasonable, but not absolute, assurance concerning the safeguarding of assets against loss from unauthorized use or disposition and concerning the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management. However, for the purposes of this report under

Rule 17a-5, the determination of weaknesses to be reported was made without considering the practicability of corrective action by management within the framework of a cost/benefit relationship.¹

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management either with respect to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the company's financial statements. It must be understood that the procedures performed are not designed, and cannot be relied on, to provide reasonable assurance that all material weaknesses in the system of internal accounting control and procedures for safeguarding securities would be disclosed.

However, pursuant to the requirements of Rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. (We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., and we believe the following additional information is required pursuant to the requirements of Rule 17a-11(f).) Or (We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., who has failed to make the required notification to the Securities and Exchange Commission. We believe the following information is required pursuant to the requirements of Rule 17a-11(f).)

¹ This sentence makes it clear that the independent auditor is not permitted, in reporting on internal control under Rule 17a-5, to use the option indicated in Section 640.13 of SAS No. 1, which states in part, "In some cases, the auditor may conclude that for certain weaknesses corrective action by management is not practicable in the circumstances, and he may decide to exclude such weaknesses from his report."

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Statements of Position

(List and describe all items concerning which the independent auditor did not agree with the notification of the broker or dealer or concerning which the required notification was not made.)

Accounting Firm

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Exhibit C

Independent Auditor's Report on Examination of Corporate Financial Statements

To the Board of Directors
Standard Stockbrokerage Co., Inc.:

We have examined the consolidated statement of financial condition of Standard Stockbrokerage Co., Inc., and Subsidiaries as of December 31, 19XX, and the related consolidated statements of income, changes in stockholders' equity, changes in subordinated liabilities, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the consolidated financial position of Standard Stockbrokerage Co., Inc., and Subsidiaries at December 31, 19XX, and the results of their operations and changes in financial position for the year then ended in conformity with generally accepted accounting principles on a basis consistent with that of the preceding year.

Also, we have examined the supplementary schedules on pages 00 to 00 and, in our opinion, they present fairly the information included therein in conformity with the rules of the Securities and Exchange Commission.

•
Accounting Firm

New York, New York
February 15, 19XX

Stockbrokerage Auditing Subcommittee

Richard V. McManus, *Chairman*
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Harvey J. Bazaar
Frank J. Borelli
Warren A. Essner
Michael P. Helmick
John J. Kilkeary
Wayne A. Kolins
Gerard Marcus

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AICPA Staff:

John F. Mullarkey, *Director*
Auditing Standards Division
Mary Lynn O'Neill, *Manager*
Auditing Standards Division

➤→ *The next page is 30,273.* ←➤

Section 11,030

Clarification of Accounting, Auditing, and Reporting Practices Relating to Hospital Malpractice Loss Contingencies

March 1, 1978

NOTICE TO READERS

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA subcommittees or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA subcommittee or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the subcommittee or task force believes would be in the public interest.

Hospital Audit Guide

Introduction

.01 In 1972, the AICPA issued the industry audit guide, *Hospital Audit Guide*. Chapter 5 of that guide includes suggested auditing procedures relating to claims against a hospital for negligence and malpractice, including possible disclosure of contingent liabilities. The size of current malpractice claim settlements, the substantial increase in malpractice insurance rates, the increasing practice of hospitals to reduce or terminate malpractice liability coverage, and other factors are conditions that differ significantly from those

prevailing at the time the guide was issued. The AICPA Subcommittee on Health Care Matters believes that item five on page 25 of the guide should be superseded and replaced by this statement of position.

Background

.02 Over the years, hospital malpractice risks were generally covered by insurance on an occurrence basis¹ at reasonable costs. Insurers found the business desirable and actively competed for it. Medicare, Medicaid, and other third-party payors have long recognized the premiums for such insurance as allowable costs of conducting the operations of a hospital.

.03 The major changes that have taken place in hospital malpractice insurance have resulted from the changing social climate in the United States. Increased emphasis on consumerism and greater public awareness of the possibility of bringing suit, among other factors, have created an entirely new environment for malpractice claims. In this environment, professionals and institutions are being treated somewhat as guarantors of the success of their efforts. Juries in court cases are disposed to awarding large amounts of money, and suits brought by individuals on reaching their majority for occurrences during their infancy have added to the problems in this area. As a result, malpractice costs have increased significantly.

.04 Insurers reacted in varying ways—by reducing or attempting to reduce the limits of their liability (for example, switching from occurrence to claims-made policies,² lowering limits on policies, and offering policies with very large deductibles), by raising premiums, and by refusing to renew policies and withdrawing from this aspect of the insurance business.

.05 Hospitals, too, reacted in a variety of ways to control the cost of malpractice insurance. Some assumed or increased deductibles in basic policies, thus becoming partially uninsured. Others chose to cancel all malpractice coverage, thus becoming totally uninsured. Hospital groups throughout the country formed captive insurance companies; however, due to insufficient experience the premiums are retrospective in many cases.

¹ A policy that insures for incidents that occur during the period of coverage is on an "occurrence" basis.

² A policy that insures for claims made during the period of coverage is on a "claims-made" basis.

.06 Some insurance commissioners have tried to force insurers to continue to insure malpractice risks, but many major insurers have withdrawn. Several state legislatures have passed laws limiting the liability of the providers and requiring an arbitration-like procedure relating to malpractice cases. However, at least one such law has been declared unconstitutional.

.07 It appears that one of the reasons for the withdrawal of insurers from this business is the difficulty of estimating potential losses. This may tend to diminish as improved estimation techniques are developed and as claims settled under present conditions become part of the body of experience. The effect of inflation represents an additional variable which complicates the process of estimating losses.

Auditing Procedures

.08 Auditors should give particular attention to whether loss contingencies resulting from malpractice risks have been accrued for and disclosed in accordance with the requirements of FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*.

.09 In evaluating the reasonableness of the accrual for estimated losses from malpractice claims, the auditor should include in his consideration the amount of insurance coverage, the insurance adjuster's evaluation of known claims, the financial reputation of the insurer, the type of coverage (claims-made or occurrence), the amount of the deductible provisions, the possibility of retrospective adjustments, and related legal and other costs.

.10 With respect to litigation, claims, and assessments, paragraph 4 of Statement on Auditing Standards No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, states that the independent auditor should obtain evidential matter relevant to the following factors:

- The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments.
- The period in which the underlying cause for legal action occurred.
- The degree of probability of an unfavorable outcome.
- The amount or range of potential loss.

.11 In addition, the auditor should apply the procedures outlined in paragraphs 5 and 6 of SAS No. 12, which are summarized below:

- Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management a description and evaluation of litigation, claims, and assessments.
- Examine documents in the client's possession concerning litigation, claims, and assessments.
- Obtain assurance from management that it has disclosed all unasserted claims that the lawyer has advised are probable of assertion and must be disclosed in accordance with FASB Statement No. 5.
- Request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.12 The independent auditor's examination normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments, such as reading minutes of meetings, contracts, agreements, and correspondence, and inspecting other pertinent documents (SAS No. 12, paragraph 7). Attention should also be given to internal controls and procedures related to identifying malpractice incidents.

.13 A letter of audit inquiry to the lawyer handling the claims is the auditor's primary means of obtaining corroboration of the information furnished by management concerning claims made and known incidents for which claims have not been made that are either uninsured or in excess of insurance coverage. SAS No. 12 should be followed to solicit legal counsel's evaluation of the likelihood of an unfavorable outcome of litigation, claims, and assessments and his estimate, if one can be made, of the amount or range of potential loss.

.14 As to unasserted claims, paragraph 30 of FASB Statement No. 5, *Accounting for Contingencies*, indicates there should be a provision for

uninsured losses resulting from injury to others or damage to the property of others that took place prior to the date of the financial statements, even though the enterprise may not become aware of those matters until after that date, if the experience of the

enterprise or other information enables it to make a reasonable estimate of the loss that was incurred prior to the date of its financial statements.

It would be appropriate for the auditor to consider prior estimates and prior loss experience, analyses of the frequency of past claims, and other actuarial considerations in evaluating the reasonableness of management's estimate of the loss (if any) that was incurred with respect to unasserted claims before the date of the financial statements. Although the experience of an individual hospital may not be statistically significant, the experience of larger units of similar character or of aggregates of similar institutions may be a useful guide.

.15 When the hospital's malpractice risks are insured on a claims-made basis, the auditor should obtain a written representation from management, if applicable, that it intends to renew the hospital's malpractice insurance coverage on a claims-made basis and that it has no reason to believe that the hospital may be prevented from renewing such coverage.

.16 The cancellation (or termination) of claims-made malpractice insurance coverage will generally cause the hospital to be at risk for all unreported incidents that occurred during the term of the cancelled policy unless, at cancellation, coverage was obtained for such incidents. Such cancellation may give rise, therefore, to a liability for unreported incidents that occurred prior to cancellation. Since terms for notifying the carrier of malpractice incidents vary, the policy should be reviewed for specific requirements.

Accounting and Disclosure

.17 The estimated loss contingency resulting from malpractice risks should be accrued for and disclosed in conformity with the provisions of FASB Statement No. 5 and FASB Interpretation No. 14. A loss contingency should be accrued for if an incident of malpractice has occurred that results in a probable loss that can be reasonably estimated. Current circumstances may make it difficult to estimate the amount of the loss. A qualified actuary may be helpful both in deriving estimates of losses incurred but not reported and in quantifying the uncertainties inherent in such estimates.³

³ In such circumstances, the independent auditor should be guided by the provisions of SAS No. 11, *Using the Work of a Specialist*.

.18 If the hospital has exposure to material malpractice contingencies in excess of amounts accruable under FASB Statement No. 5 and FASB Interpretation No. 14, such contingencies should be disclosed in accordance with paragraphs 9 through 11 of FASB Statement No. 5.

.19 Because of the significance of malpractice risks and the related costs, disclosure of a hospital's policy with regard to malpractice insurance coverage and changes in that policy may be necessary for presentation of the financial statements in conformity with generally accepted accounting principles. If premiums are determined retrospectively, disclosure of that fact may be necessary. Particular attention should be paid to paragraphs 44 and 45 of FASB Statement No. 5 if a hospital or group of hospitals insures malpractice risks through a captive or joint insurance company or if a hospital's malpractice insurance premiums are determined retrospectively.

.20 FASB Statement No. 5 requires disclosure of unasserted claims only if it is probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable. Because of the significance of malpractice risks to hospitals, the Subcommittee on Health Care Matters recommends that hospitals also disclose in their financial statements the possibility of losses from unasserted claims that do not meet those criteria.

.21 An example of appropriate financial statement disclosure of uncertainties arising from possible malpractice follows.

Malpractice claims in excess of insurance coverage have been asserted against the hospital by various claimants. The claims are in various stages of processing and some may ultimately be brought to trial. Counsel is unable to conclude about the ultimate outcome of the actions. There are known incidents occurring through (balance sheet date) that may result in the assertion of additional claims, and other claims may be asserted arising from services provided to patients in the past. The hospital is unable to estimate the ultimate cost, if any, of the settlement of such potential claims and, accordingly, no accrual has been made for them.

.22 If the hospital has changed its malpractice insurance coverage from an occurrence basis policy to a claims-made policy, it may be appropriate to disclose the related facts and circumstances in the financial statements. The following is an example of such disclosure.

Effective January 1, 19XX, the hospital changed its malpractice insurance coverage from an occurrence basis policy to a claims-made policy. Claims based on occurrences prior to January 1, 19XX, are insured under the old policy. Should the claims-made policy not be renewed or replaced with equivalent insurance, claims based on occurrences during its term but reported subsequently will be uninsured.

.23 In the first year a hospital is uninsured for its malpractice risks to any material degree, whether by use of deductibles or otherwise, the related facts and circumstances should be described in the financial statements. Such disclosure should include the effect on comparability of insurance expense in the year of change. The following is an example of such disclosure.

The hospital has terminated its malpractice coverage as of the beginning of the current year. In the prior year, malpractice insurance premiums in the amount of \$ _____ were charged to income. During the current year, no charges for premiums or for actual or potential claims have been made.

.24 Information may become available after the balance sheet date, but before the issuance of the auditor's report, indicating that it was probable that a malpractice loss had been incurred as of the balance sheet date. When the amount of the loss can be reasonably estimated, it should be accrued by a charge to income (see paragraph 8 of FASB Statement No. 5). An example would be the filing of a claim after the balance sheet date which relates to services rendered prior to that date. Information may become available after the balance sheet date, but before the issuance of the auditor's report, which may require disclosure so that the financial statements will not be misleading (see paragraph 11 of FASB Statement No. 5). An example of a subsequent event that may require disclosure is the termination of a hospital's malpractice insurance coverage.

.25 Malpractice loss amounts eligible for reimbursement by third-party payors may be materially different from amounts accruable under FASB Statement No. 5. Recognition should be given to the effect of timing differences that may result.⁴ In addition, any restrictions on funds required to be set aside should be disclosed.

⁴ See page 5 of the *Hospital Audit Guide* for the discussion, "Third-Party Reimbursement Timing Differences."

Reporting Considerations

.26 If the estimated loss arising from alleged malpractice is accrued for and disclosed in conformity with the provisions of paragraphs 8 through 11 of FASB Statement No. 5 and FASB Interpretation No. 14, and if there is no material exposure to losses from claims and potential claims in excess of the amount accrued, or if all claims and potential claims are adequately covered by insurance, the auditor should not modify his report with respect to such claims.

.27 Statement on Auditing Standards No. 2, paragraph 15, states that the auditor should express a qualified or an adverse opinion when financial statements examined in accordance with generally accepted auditing standards are materially affected by a departure from generally accepted accounting principles. The following is an example of a modification of the auditor's report, along with an example of appropriate financial statement disclosure, when a hospital makes a provision for malpractice losses that is materially different from the amount that should be accrued under FASB Statement No. 5 and FASB Interpretation No. 14.

(Scope Paragraph—Standard Wording)
(Separate Paragraph)

As described in Note X, claims for alleged malpractice in excess of insurance coverage have been asserted against the hospital by various claimants, and additional material claims may be asserted arising from services provided to patients in the past. The hospital has charged income with a provision of \$_____ for losses related to uninsured malpractice claims. The ultimate liability of the hospital resulting from such claims is not presently determinable. Generally accepted accounting principles preclude a charge to income for a provision for loss contingencies that cannot be reasonably estimated.

(Opinion Paragraph)

In our opinion, except for the effect of recording a provision for losses related to malpractice claims which cannot be reasonably estimated, the financial statements referred to above present fairly . . . in conformity with generally accepted accounting principles. . . .

(Financial Statement Disclosure)

Malpractice claims in excess of insurance coverage have been asserted against the hospital by various claimants, and additional claims may be asserted for known incidents through (balance sheet date). The claims are in various stages of processing and some may ultimately be brought to trial. Counsel is unable to

conclude about the ultimate outcome of the actions commenced. Moreover, additional material claims arising from services provided to patients in the past may be asserted. The hospital is unable to estimate the ultimate cost of the settlement of such potential claims. Although the amount of the losses from uninsured malpractice claims cannot be reasonably estimated, the hospital considers it prudent to record a provision for such losses and accordingly has charged income with a provision of \$_____.

.28 The auditor should consult relevant statements on auditing standards to determine the need, if any, for otherwise modifying his report because of malpractice contingencies.

Subcommittee on Health Care Matters

ALBERT A. CARDONE, *Chairman*
RONALD B. ASHWORTH
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Senior Manager
Federal Government
Relations Division
ROBERT C. MULLINS, *Manager*
Federal Government
Relations 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, Robert A. Jordan, Robert F. Rosenstiel, and Allen J. Winick, and by former AICPA staff aide to the subcommittee, Edward J. Mazur.

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Section 11,040

**Confirmation of Insurance
Policies in Force**

August 1978

NOTICE TO READERS

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of those guides, AICPA committees may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA committee.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to those matters, members should be aware that they may be called on to justify departures from the recommendations of the committee.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the committee believes would be in the public interest.

.01 In February 1975, the AICPA Special Committee on Equity Funding stated ". . . except for certain observations relating to confirmation of insurance in force and auditing related party transactions, generally accepted auditing standards are adequate and . . . no changes are called for in the procedures commonly used by auditors." The AICPA industry audit guide, *Audits of Stock Life Insurance Companies* (page 32), states: "It may also be appropriate to select in-force policies for confirmation directly with policyholders of premium amounts, date to which premiums are paid, policy loans, accumulated dividends, etc." The special committee recommended "that the Institute's auditing standards executive committee consider whether the Life Insurance Audit Guide requires clarification with regard to the confirmation of policies with policyholders."

.02 The special committee further stated:

Another auditing procedure, which heretofore has not been considered particularly useful, is verification of the authenticity of a selected number of policies included in the in-force inventory by direct confirmation with the policyholders. Such a procedure has not generally been considered necessary because it would be unusual for companies to overstate liabilities. Inflation of the inventory of life insurance in force by a company that follows statutory accounting would result in an overstatement of the liability for future policyholder benefits and a reduction in current earnings. However, when companies report on the basis of generally accepted accounting principles (GAAP) there could be motivation for overstating insurance in force because it could result in an addition to current earnings.

There could be an additional motivation for overstating insurance in force when reinsurance of policies has the effect of materially increasing current earnings, which can occur when a company reports on the basis of either GAAP or statutory accounting. Reinsurance of life insurance policies permits the elimination of the related liability for future policyholder benefits. Under certain circumstances, reinsurance may also result in increasing current earnings to the extent that the proceeds received from reinsurance exceed expenses incurred in connection with the sale and servicing of the reinsured policies.

.03 As stated above, the audit guide suggests confirmation of insurance policies in force directly with policyholders; however, the audit guide does not discuss circumstances when confirmation would be appropriate and, as a result, practice has varied. The purpose of this statement of position is to identify those circumstances in which the independent auditor ordinarily should confirm insurance policies in force. This statement of position is applicable to both stock and mutual life insurance companies.

.04 Satisfactory results of the comparison of insurance policies in force with premium collections along with other ordinary auditing procedures (see pages 31-34, 46-47, and 96 of the audit guide) will normally provide the auditor with sufficient competent evidential matter as to the validity of those policies included in the inventory of insurance policies in force. However, the auditor ordinarily should confirm insurance policies in force with policyholders in the following circumstances:

- a. Proper maintenance of the inventory of insurance in force may be materially deficient due to an absence of segregation of duties or other controls.
- b. Trend analyses or ratios that measure insurance in force indicate erratic or unusual results that have not been satisfactorily explained.
- c. Additions to insurance in force cannot be related to the collection of premiums.
- d. Significant amounts of insurance in force result from related party transactions, and the related party's financial statements are not examined by the auditor.
- e. The company markets insurance products, such as those with immediate cash value features or with unusual commissions arrangements, that could motivate the agent to submit fictitious policies.
- f. Ceded reinsurance activities can materially increase earnings or investable funds.

Effective Date

.05 This statement of position provides for practices that may differ in certain respects from present acceptable practices. Accordingly, this statement of position will be effective for examinations made in accordance with generally accepted auditing standards for periods ending on or after December 31, 1978.

Insurance Companies Committee

JOHN E. HART, *Chairman*
EDWARD F. BADER
CORMICK L. BRESLIN
FRANK A. BRUNI
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AICPA Staff:

D. R. CARMICHAEL, *Vice President*
Auditing Standards
DAVID V. ROSCETTI, *Manager*
Auditing Standards

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Section 11,050**Report on a Financial
Feasibility Study**

Supplements the *Guide for a
Review of a Financial Forecast*

October 1982

NOTICE TO READERS

This Statement of Position presents the recommendations of the Financial Forecasts and Projections Task Force regarding reporting on financial feasibility studies. It represents the considered opinion of the task force on the best reporting practice for such engagements and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departure from the recommendations contained in this statement if their work is challenged.

(This Statement of Position should be read and applied in conjunction with the *Guide for a Review of a Financial Forecast*.)

.01 In 1980, the AICPA issued the *Guide for a Review of a Financial Forecast*. The guide defines a feasibility study as an analysis of a proposed investment or course of action. Although the guide was not intended to cover all aspects of feasibility studies, it does apply to the review of a forecast included in a feasibility study and an accountant's report thereon.

.02 Preparation of a financial feasibility study generally includes such elements as the following:

- Analyzing program history, objectives, timing, and financing
- Analyzing demand
- Assisting management to identify key factors on which future financial results will depend
- Assisting management to develop assumptions that form the basis for the forecast
- Assembling the forecast (that is, performing the mechanical aspects of translating the assumptions into the forecast)
- Reviewing the financial forecast, which permits expressing conclusions on whether (a) the assumptions provide a reasonable

basis for the forecast and (b) the forecast is presented in conformity with applicable presentation guidelines

- Concluding whether the forecast indicates that sufficient funds could be generated to meet operating and debt service requirements

When the financial feasibility study includes such procedures, the accountant's report on the study often describes them and his conclusions.

.03 The guide provides for such an expanded report stating,

The report [on a review of a financial forecast] may also present other information and comments the accountant wishes to include such as . . . explanatory comments or other informative material.¹

The other information and comments may describe the nature of the work performed and conclusions reached with regard to other aspects of the financial feasibility study.

.04 Following is a report that might be issued when an accountant chooses to expand his report on a financial feasibility study. Although the entity referred to in the report is a hospital, the form of report is applicable to other entities, such as a hotel or a stadium.

.05 Although the following report format and language should not be departed from in any significant way, the language used should be tailored to fit the circumstances that are unique to a particular engagement (for example, the description of the proposed capital improvement program, paragraph *c*; the proposed financing of the program, paragraphs *b* and *d*; the specific procedures applied by the accountant, paragraph *e*; and any explanatory comments included in emphasis-of-a-matter paragraphs, paragraph *j*, which deals with a general matter, and paragraph *k*, which deals with specific matters).

Expanded Report

a. The Board of Directors
Example Hospital
Example, Texas

b. We have prepared a financial feasibility study of the Example Hospital's plans to expand and renovate its facilities. The study was undertaken to

¹ AICPA, *Guide for a Review of a Financial Forecast* (New York 1980) p 22.

evaluate the ability of the Example Hospital (the Hospital) to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed \$25,000,000 [legal title of bonds] issue, at an assumed average annual interest rate of 10.0 percent, during the five years ending December 31, 19X6.

- c. The proposed capital improvements program (the Program) consists of a new two-level addition which is to provide fifty additional medical-surgical beds, increasing the complement to 275 beds. In addition, various administrative and support service areas in the present facilities are to be remodeled. The Hospital administration anticipates that construction is to begin June 30, 19X2, and to be completed by December 31, 19X3.
- d. The estimated total cost of the Program is approximately \$30,000,000. It is assumed that the \$25,000,000 of revenue bonds that the Example Hospital Finance Authority proposes to issue would be the primary source of funds for the Program. The responsibility for payment of debt service on the bonds is solely that of the Hospital. Other necessary funds to finance the Program are assumed to be provided from Hospital funds, from a local fund drive, and from interest earned on funds held by the bond trustee during the construction period.
- e. Our procedures included analysis of
 - Program history, objectives, timing, and financing.
 - The future demand for the Hospital's services, including consideration of
 - Economic and demographic characteristics of the Hospital's defined service area.
 - Locations, capacities, and competitive information pertaining to other existing and planned area hospitals.
 - Physician support for the Hospital and its programs.
 - Historical utilization levels.
 - Planning agency applications and approvals.
 - Construction and equipment costs, debt service requirements, and estimated financing costs.
 - Staffing patterns and other operating considerations.
 - Third-party reimbursement policy and history.
 - Revenue/expense/volume relationships.
- f. We also participated in gathering other information, assisted management in identifying and formulating its assumptions, and assembled the accompanying financial forecast based upon those assumptions.
- g. The accompanying financial forecast for the annual periods ending December 31, 19X2 through 19X6 is based upon assumptions that were

provided by or reviewed with and approved by management. The financial forecast includes

- Balance sheets.
 - Statements of revenues and expenses.
 - Statements of changes in financial position.
 - Statements of changes in fund balance.
- h.* The financial forecast presents management's estimate of the most probable financial position, results of operations, and changes in financial position and fund balance for the forecast periods. Accordingly, the forecast reflects its judgment, based on present circumstances, of the most likely set of conditions and its most likely course of action.
- i.* We have made a review of the financial forecast in accordance with applicable guidelines for a review of a financial forecast established by the American Institute of Certified Public Accountants. Our review included those procedures we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.
- j.* Legislation and regulations at all levels of government have affected and may continue to affect revenues and expenses of hospitals. The financial forecast is based upon legislation and regulations currently in effect. If future legislation or regulations related to hospital operations are enacted, such legislation or regulations could have a material effect on future operations.
- k.* The interest rate, principal payments, Program costs, and other financing assumptions are described in the section entitled "Summary of Significant Forecast Assumptions and Rationale." If actual interest rates, principal payments, and funding requirements are different from those assumed, the amount of the bond issue and debt service requirements would need to be adjusted accordingly from those indicated in the forecast. If such interest rates, principal payments, and funding requirements are lower than those assumed, then such adjustments would not adversely affect the forecast.
- l.* Our conclusions are presented below:
- We believe that the accompanying financial forecast is presented in conformity with applicable guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants.
 - We believe that the underlying assumptions provide a reasonable basis for management's forecast. However, some assumptions inevitably will not materialize and unanticipated events and circumstances may occur, therefore, the actual results achieved during the forecast periods will vary from the forecast, and the variations may be material.

- The accompanying financial forecast indicates that sufficient funds could be generated to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed \$25,000,000 bond issue, during the forecast periods. However, the achievement of any financial forecast is dependent upon future events, the occurrence of which cannot be assured.
- m. We have no responsibility to update this report for events and circumstances occurring after the date of this report.
- n. (Date)

Effective Date

.06 The provisions of this statement shall be effective for accountants' expanded reports on financial feasibility studies dated on or after November 30, 1982.

Financial Forecasts and Projections Task Force

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The task force acknowledges the substantial contribution to the development of this statement made by Robert W. Berliner, David L. Fleisher, John J. Fox, Richard J. Kasten, Robert Mednick, Ronald W. Ruppel, and Wayne Williamson.

➤➤➤ → *The next page is 30,319.* ← ➤➤➤

Section 11,060***Auditing Property and
Liability Reinsurance***

Supplements *Audits of Fire
and Casualty Insurance Companies*

October 1982

NOTICE TO READERS

This statement of position presents recommendations of the Reinsurance Auditing and Accounting Task Force of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards in auditing property and liability reinsurance. This statement of position supplements the industry audit guide, *Audits of Fire and Casualty Insurance Companies*. It represents the considered opinion of the AICPA Reinsurance Auditing and Accounting Task Force on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Introduction

.01 Reinsurance is the assumption by one insurer of all or part of a risk originally undertaken by another insurer. Reinsurance is not transacted directly with the general public, but, instead, between insurance companies. In the United States there are basically three types of reinsurance entities: professional reinsurers, reinsurance departments of primary insurance companies, and various groups or syndicates of insurers referred to as reinsurance pools or associations.

- *Professional reinsurers*, while likely permitted by their charters and licenses to operate as primary insurance companies, engage almost exclusively in reinsurance.
- *Reinsurance departments* of primary insurance companies function as units of primary insurers and engage in the reinsurance business.
- *Reinsurance pools* (also referred to as associations or syndicates) may be organized to provide their members with reinsurance protection and management for certain specialized, high-risk

coverage or with general access to the reinsurance market for traditional lines of business.

In addition, reinsurance intermediaries (including brokers, agents, managing general agents, and similar entities) facilitate the business of reinsurance by bringing together reinsurance purchasers and sellers. The functions of reinsurance entities may include underwriting, designing and negotiating the terms of reinsurance, placing reinsurance, accumulating and reporting transactions, distributing premiums, and collecting and settling claims.

.02 Major reasons for insurance companies to enter reinsurance contracts are to—

- a. Reduce their exposure on particular risks or classes of risks.
- b. Protect against accumulations of losses arising from catastrophes.
- c. Reduce their total liabilities to a level appropriate to their premium volumes and amounts of capital.
- d. Provide financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted.
- e. Help stabilize operating results.
- f. Obtain assistance with new products and lines of insurance.

For similar reasons, reinsurers may at times reinsure their own risks with other insurance and reinsurance companies, a practice known as retrocession.

.03 Reinsurance may be transacted under broad, automatic contracts called “treaties,” which are usually of long duration and which cover some portion of a particular class of business underwritten by the insurers. Reinsurance may also be transacted under “facultative” agreements, which cover specific individual risks and require the insurer and reinsurer to agree on terms and conditions of reinsuring each risk. Reinsurance may either be “pro rata,” in which the reinsurer and the insurer share proportionately in the premiums and losses, or “excess,” in which only the insurer’s losses above a fixed point, known as the “retention,” are reinsured. (For a description of the various types of reinsurance transactions, see the AICPA Industry Audit Guide, *Audits of Fire and Casualty Insurance Companies*, pages 5–8.)

.04 In ceding all or part of a risk the “ceding company” does not discharge its primary liability to its insureds. The ceding company

remains fully liable for the face amount of the policy issued. Through reinsurance, the ceding company reduces its maximum exposure in the event of loss by obtaining the right to reimbursement from the “assuming company” for the reinsured portion of the loss.

.05 The accounting entries for reinsurance ceded transactions are the opposite of the entries that arise from direct business. The amounts for reinsurance transactions are usually netted against the related accounts in financial statements. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, describes in paragraph 38 the accounting for ceded reinsurance:

Amounts that are recoverable from reinsurers and that relate to paid claims and claim adjustment expenses shall be classified as assets, with an allowance for estimated uncollectible amounts. Estimated amounts recoverable from reinsurers that relate to the liabilities for unpaid claims and claim adjustment expenses shall be deducted from those liabilities. Ceded unearned premiums shall be netted with related unearned premiums. Receivables and payables from the same reinsurer, including amounts withheld, also shall be netted. Reinsurance premiums ceded and reinsurance recoveries on claims may be netted against related earned premiums and incurred claim costs in the income statement.¹

.06 The accounting entries for reinsurance assumed normally parallel those for direct insurance. However, the extent of the detail in the information provided to the assuming company by the ceding company or the reinsurance intermediary can vary significantly regarding—

- a. Timeliness of the information submitted.
- b. Detail of information relating to policies, claims, unearned premiums, and loss reserves.
- c. Annual statement line-of-business classification.
- d. Foreign currency translation information on business assumed from companies domiciled in foreign countries (“alien companies”).

Information on losses incurred but not reported (IBNR) and bulk reserves also may be provided by ceding companies under pro rata

¹ FASB Statement No. 60, paragraph 60f also specifies the following disclosures regarding reinsurance. “The nature and significance of reinsurance transactions to the insurance enterprise’s operations, including reinsurance premiums assumed and ceded, and estimated amounts that are recoverable from reinsurers and that reduce the liabilities for unpaid claims and claim adjustment expenses.”

reinsurance arrangements. Generally no IBNR will be provided on nonproportional (excess) reinsurance arrangements. Based on the quality and comprehensiveness of the detail presented, the information provided may or may not be used by the assuming company.

.07 FASB Statement No. 60 describes reporting in conformity with generally accepted accounting principles for “payments to insurance companies that may not involve transfer of risk.” Similar guidance is provided in FASB Statement No. 5, paragraph 44. Paragraph 40 of FASB Statement No. 60 states—

To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the ceding enterprise is a deposit, the amount paid shall be accounted for as such. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

Applicability and Scope

.08 This statement provides guidance on auditing property and liability reinsurance, including accident and health reinsurance. The following sections describe certain significant aspects of internal accounting control regarding ceded reinsurance and assumed reinsurance and describe the related auditing procedures. SAS No. 1, section 320.31, states, “The establishment and maintenance of a system of internal control is an important responsibility of management.” The concept of materiality is inherent in the work of the independent auditor, and the elements of materiality and relative risk underlie the application of generally accepted auditing standards.

Ceded Reinsurance

Internal Controls of the Ceding Company

.09 The ceding company should have those internal accounting control procedures that it considers necessary to (a) evaluate the financial responsibility and stability of the assuming company (whether the assuming company is domiciled in the United States or in a foreign country) and (b) provide reasonable assurance of the

accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company. The ceding company's control procedures to evaluate the financial responsibility and stability of the assuming company may include—

- a.* Obtaining and analyzing recent financial information of the assuming company, such as—
 - Financial statements and, if audited, the independent auditor's report.
 - Financial reports filed with the Securities and Exchange Commission (U.S.), Department of Trade (U.K.), or similar authorities in other countries.
 - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development and the quality and liquidity of the company's invested assets.
- b.* Obtaining and reviewing available sources of information relating to the assuming company, such as—
 - Insurance industry reporting and rating services.
 - Insurance department examination reports.
 - Loss reserve certifications filed with regulatory authorities.
 - Letters relating to the adequacy of internal accounting controls filed with regulatory authorities.
 - Insurance Regulatory Information System results filed with regulatory authorities.
- c.* Inquiring about the assuming company's retrocessional practices and experience.
- d.* Inquiring about the general business reputation of the assuming company and the background of its owners and management.
- e.* Ascertaining whether the assuming company is authorized to transact reinsurance within the ceding company's state of domicile or whether letters of credit or other means of security are provided if the assuming company is not so authorized.
- f.* Considering the need for and evaluating the adequacy of collateral from the assuming company on certain reinsurance contracts.

.10 The ceding company's control procedures relating to the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company are generally similar in nature to other control procedures for the recording of insurance transactions. Those control procedures are not addressed in this statement.

Auditing Procedures

.11 In the study and evaluation of internal control, the ceding company's independent auditor should review the ceding company's procedures for determining the assuming company's ability to honor its commitments under the reinsurance contract. If the auditor intends to rely on the prescribed procedures, he should perform tests of the ceding company's procedures to obtain reasonable assurance that they are in use and operating as planned.

.12 The absence of adequate procedures by the ceding company to determine the assuming company's ability to honor its contractual commitments, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the ceding company's system of internal accounting control.² If the auditor decides not to rely on the company's control procedures, whether because of a material weakness or other reasons, he should extend his procedures to evaluate the collectibility of amounts recorded in the financial statements as recoverable from the assuming company. The auditor's extended procedures may include certain of the procedures specified in paragraph .09, but they are not necessarily limited to those procedures. The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 2, paragraphs 10-13). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.13 To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the ceding company should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

² SAS No. 1, section 320, states, "A material weakness is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions" (as amended by SAS No. 30). SAS No. 20 requires the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that the auditor becomes aware of through his examination.

- a. Read the reinsurance contract and related correspondence to—
 - Obtain an understanding of the business objective of the reinsurance contract, and
 - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60, paragraph 40 (see paragraph 7, above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.
- c. Trace the selected transactions to supporting documents and test the related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Assumed Reinsurance

Internal Controls of the Assuming Company

.14 A significant element of the assuming company's system of internal accounting control related to assumed reinsurance is appropriate control procedures that the company considers necessary for assessing the accuracy and reliability of data received from the ceding company (whether the ceding company is domiciled in the United States or in a foreign country). Principal control procedures of the assuming company may include—

- a. Maintaining an underwriting file with information relating to the business reasons for entering the reinsurance contract and anticipated results of the contract. The underwriting file may include—
 - Historical loss ratios and combined ratios of the ceding company.
 - Anticipated loss ratios under the contract.
 - An indication of the frequency and content of reports from the ceding company.
 - Prior business experience with the ceding company.
 - The assuming company's experience on similar risks.
 - Information regarding pricing and ceding commissions.
- b. Monitoring the actual results reported by the ceding company and investigating the reasons for and the effects of significant deviations from anticipated results.
- c. Visiting the ceding company and reviewing and evaluating its underwriting, claims processing, loss reserving, and loss reserve development monitoring procedures.

d. Obtaining from the ceding company a special-purpose report by their independent accountant regarding the ceding company's internal accounting controls relating to ceded reinsurance (see SAS No. 30, *Reporting on Internal Accounting Control*, paragraphs 60–61).

.15 Additional control procedures of the assuming company may include—

- a. Obtaining and analyzing recent financial information of the ceding company, such as—
- Financial statements and, if audited, the independent auditor's report.
 - Financial reports filed with the Securities and Exchange Commission (U.S.), Department of Trade (U.K.), or similar authorities in other countries.
 - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development.
- b. Obtaining and reviewing available sources of information on the ceding company, such as—
- Insurance industry reporting and rating services.
 - Insurance department examination reports.
 - Loss reserve certifications filed with regulatory authorities.
 - Letters relating to the adequacy of internal accounting controls filed with regulatory authorities.
 - Insurance Regulatory Information System results filed with regulatory authorities.
- c. Inquiring about the general business reputation of the ceding company and the background of its owners and management.

Auditing Procedures

.16 In the study and evaluation of internal control, the assuming company's independent auditor should review the assuming company's procedures for assessing the accuracy and reliability of data received from the ceding company. If the auditor intends to rely on the prescribed procedures, he should perform tests of the company's procedures to obtain reasonable assurance that they are in use and operating as planned.

.17 The absence of adequate procedures by the assuming company to obtain assurance regarding the accuracy and reliability of data received from the ceding company, or the lack of reasonable assurance that such procedures are in use and operating as planned,

may constitute a material weakness in the assuming company's system of internal accounting control.³ If the auditor decides not to rely on the company's control procedures, whether because of a material weakness or other reasons, he should extend his procedures to obtain assurance regarding the accuracy and reliability of the data received from the ceding company. The auditor's extended procedures should ordinarily include, but would not necessarily be limited to, one or more of the following:

- a. Performing certain of the principal control procedures specified in paragraph .14
- b. Visiting the ceding company's independent auditor and reviewing his working papers (See SAS No. 1, section 543.12.)
- c. Performing auditing procedures at the ceding company or requesting the independent auditor of the ceding company to perform agreed-upon procedures
- d. Obtaining a special-purpose report from the ceding company's independent auditor on design and compliance test of the company's internal controls relating to ceded reinsurance (See SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations.*)

The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 2, paragraphs 10–13). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.18 To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the assuming company should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

- a. Read the reinsurance contract and related correspondence to—
 - Obtain an understanding of the business objective of the reinsurance contract.

³ See footnote 2

- Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60, paragraph 40 (see paragraph .07, above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.
- c. Trace the selected transactions to supporting documents and test the related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Pools, Associations, and Syndicates

.19 Participation in reinsurance pools, associations, and syndicates is in some respects similar to reinsurance, and the guidance in paragraphs .14-.18 is generally applicable in the audit of an assuming company (participating company). Pools, associations, and syndicates often issue audited financial statements to participating companies, and the auditor of a participating company may use the report of the independent auditor of the pool, association, or syndicate in his examination. Guidance on the auditor's considerations in those circumstances is provided in SAS No. 1, section 543, "Part of Examination Made by Other Independent Auditors."

Reinsurance Intermediaries

.20 Reinsurance may be transacted and serviced directly between the ceding and assuming companies or through reinsurance intermediaries (including brokers, agents, managing general agents, or similar entities). When a reinsurance intermediary is involved, the control procedures of the reinsurance intermediary are an integral part of the reinsurance transaction. The assuming and ceding companies should coordinate their control procedures with those of the reinsurance intermediary.

.21 A company may delegate to a reinsurance intermediary the performance of the procedures described in paragraphs .09 and in .14 and .15. The company, however, should have procedures to satisfy itself that the reinsurance intermediary is adequately performing those procedures. The guidance provided the independent auditor in paragraphs .11 and .12 and in .16 and .17 is applicable.

.22 In addition to the functions discussed in paragraphs .09 and in .14 and .15, a reinsurance intermediary may be authorized to

collect, hold, disburse, and remit funds on behalf of the insurance company. The insurance company should have controls to provide reasonable assurance that the reinsurance intermediary is—

- a. Adequately performing those functions.
- b. Safeguarding the funds and, if required, appropriately segregating the funds.
- c. Settling accounts on a timely basis.

The insurance company may accomplish this by obtaining a special report from the independent auditor of the reinsurance intermediary or by visiting the reinsurance intermediary and reviewing its controls relating to those functions. The auditor of the insurance company should review the company's internal control procedures, and, if he intends to rely on them, he should test the operation of those control procedures. If the auditor decides not to rely on those controls, he should extend his procedures to obtain assurance that the objectives described in *a – c* above are met.

Effective Date

.23 This statement of position provides for practices that may differ in certain respects from present practices. Accordingly, this statement of position will be effective for examinations made in accordance with generally accepted auditing standards for periods ending on or after December 31, 1983. Earlier application is encouraged.

Reinsurance Auditing and Accounting Task Force

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IP Section 15,000

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OCR Section 20,000

VOLUNTARY QUALITY CONTROL REVIEW PROGRAM FOR CPA FIRMS

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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.

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➤→ *The next page is 31,813.* ←➤

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.¹ 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

¹ *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.²

.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.³ These sample documents were

² *Management of an Accounting Practice Handbook* (New York: AICPA, 1977).

³ 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.⁴
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.)

⁴ 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.¹ 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.

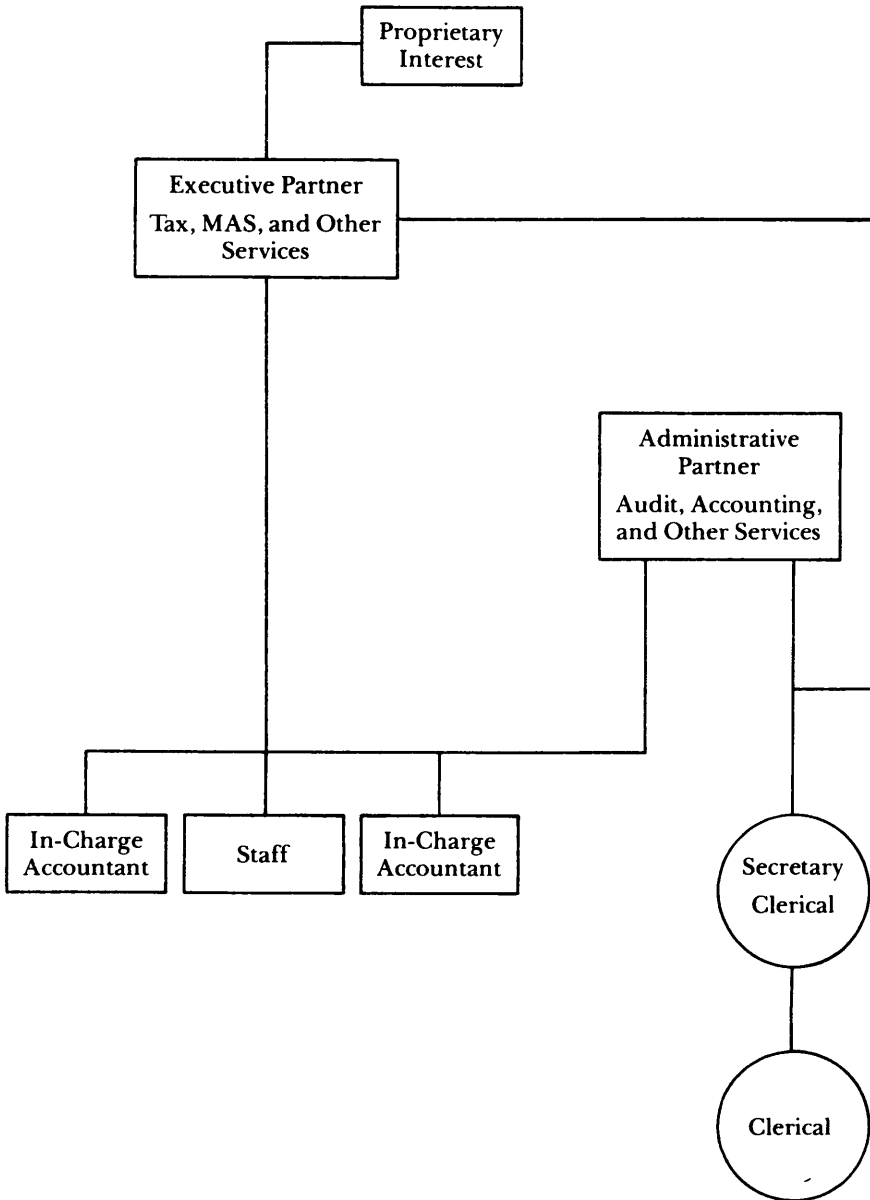
There were approximately 9,250 hours billed during the year ended December 31, 1977, as follows:

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.

¹ 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.²
- 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.

² 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.³
 - 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-**

³ 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.¹ 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.

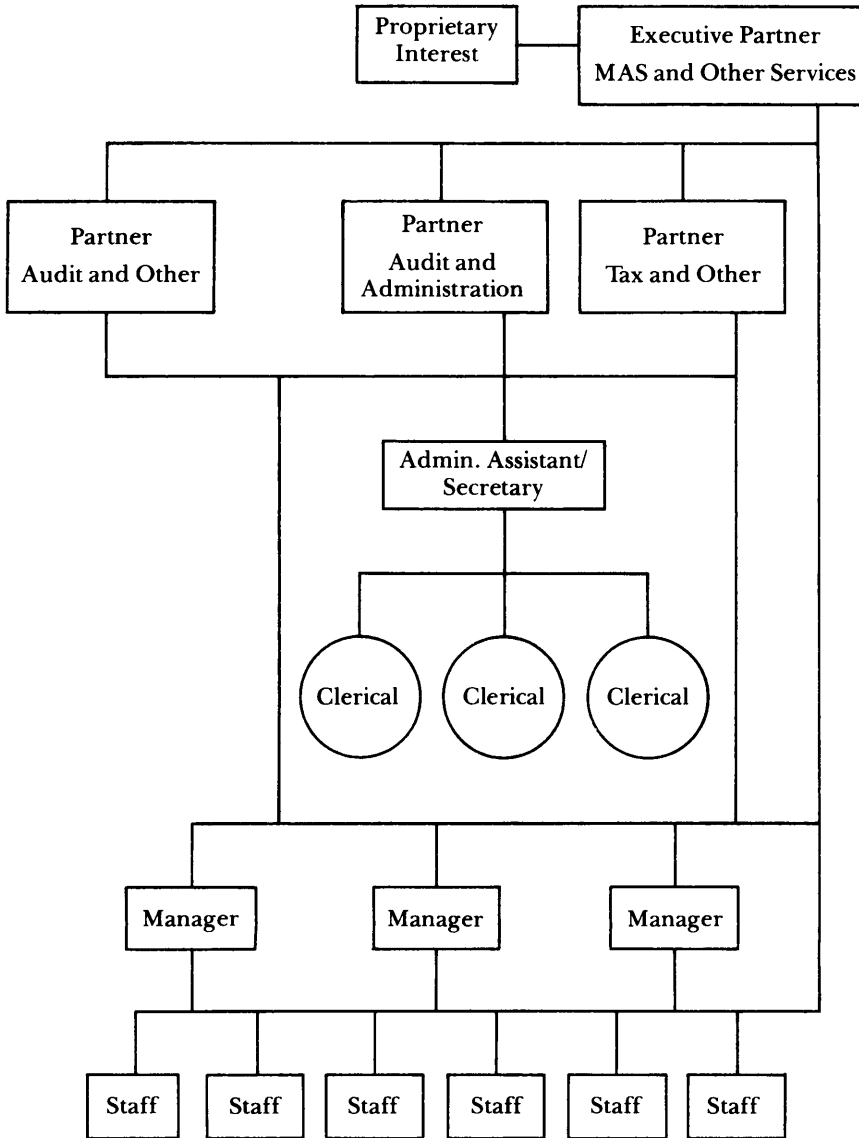
We hope to be a firm that is enjoyable and rewarding to work for. We intend to continue our involvement in and contribution to community and professional activities and organizations.

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>

¹ 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.²
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

² 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 hires 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.³
 - (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.

³ 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 LevelsProfile 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-

- gagements 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>
Assigning Personnel to Engagements	
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
Consultation	
Industry Competency Questionnaire	305-4
A Suggested Firm Library	505
Supervision	
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
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Preface

The following section has been prepared by the AICPA staff to provide guidance to firms intending to participate in the AICPA Voluntary Quality Control Review Program for CPA Firms. It has not been endorsed by any committee of the Institute and is not, therefore, authoritative.

November 1978

»»»→ *The next page is 31,873.* ←«««

QCR Section 20,510**Sample Quality Control Documents
for Sole Practitioner CPA Firms**

November 1978

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.¹ In 1977, the Institute published sample quality control documents for two-partner and four-partner local CPA firms to provide guidance for local practitioners in the development of their quality control documents. The quality control standards committee has decided that sample quality control documents should be available to assist sole practitioners to develop their own quality control documents.

.02 In undertaking this guidance project, many alternative objectives and implementation procedures were considered. The primary consideration in the preparation of these sample documents was to design them to help practitioners apply the concepts of quality control standards in developing and using a quality control document in their particular circumstances. A secondary consideration was that a quality control document cannot be standardized—it 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),

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 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.

¹ *Voluntary Quality Control Review Program for CPA Firms* (New York: AICPA, 1976) [Also printed in *AICPA Professional Standards*, Volume 2, QC section 100.]

.03 The preparation of sample documents first requires the availability of model practices. The hypothetical models presented herein have been drawn from the membership applications submitted by sole practitioners to the AICPA Division for CPA Firms.

.04 The policies and procedures discussed 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 that could be adapted by a specific firm to provide itself with reasonable assurance of conforming 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 may be influenced by appropriate cost/benefit considerations.

.05 In this section, *policies* (which are numbered and in bold type) refer to the firm's objectives and goals concerning the elements of quality control. *Procedures* (which are lettered) refer to the steps taken to comply with the policies adopted. Unless otherwise stated, *personnel* encompasses all of the professionals associated with the participating firm's auditing and accounting and review practice and includes proprietors, partners, principals, and stockholders or officers of professional corporations, and their professional employees.

.06 The following sample quality control documents have been prepared to provide guidance to sole practitioners in developing their quality control documents.² Although the sample quality control documents are designed for firms of specific sizes, they may be modified for firms of various other sizes. However, because 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.

.07 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 characteristics. Similarly, procedures that are applied to implement the policies follow the format of material contained in the guide and are based upon the size, structure, and nature of practice of each firm. The document for the sole CPA practitioner with full-time staff is more extensive than the document for the sole CPA prac-

² A firm's quality control policies and procedures need not be contained in a single quality control document. A firm may meet the requirement 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.

tioner without full-time staff, because the structure of the firm with full-time staff is more complex.

.08 The need for procedures that are responsive to each firm's practice should be kept in mind in preparing a quality control document. For example, although both firms have identical policies relating to supervision, the procedures applied to implement the policies are more extensive for the sole CPA practitioner with full-time staff because of the delegation of authority. Similarly, the hiring procedures for the sole CPA practitioner without full-time staff are less extensive because of the limited hiring plans. The elements of supervision and hiring have been used to illustrate how quality control objectives might be achieved with procedures that differ because of the specific needs of each practice; similar examples are to be found in the other elements. The sole practitioner might find an arrangement with another CPA firm to be helpful in some of the elements, such as consultation, professional development, and inspection.

.09 The sole CPA practitioner may find the following steps to be helpful during the preparation of a quality control document:

1. Become familiar with the guide and the program.
2. Establish a schedule to accomplish various steps.
3. Gather together all current firm materials relating to the elements of quality control, such as manuals, memorandums, forms, checklists, and so forth. If possible, obtain similar materials from other firms.³
4. For each of the nine elements of quality control, specify the firm's current policies and procedures.
5. Evaluate the applicability of existing policies and procedures.
6. Consistent with the firm's size, organizational structure, the nature of its practice, and so forth, consider establishing new policies and procedures using the guide and sample documents as aids.
7. Prepare a statement of the firm's objectives, a brief history, and some details about its practice.
8. Draft the quality control document element by element. As each element is written, the firm may find it helpful to refer simultaneously to the section in the guide for the particular element and to the sample documents.

³ Appendix B contains a list of *Management of an Accounting Practice Handbook* forms (New York: AICPA) that relate to quality control and may be adaptable to the firm.

9. If desired, submit the final draft to the American Institute of Certified Public Accountants for a confidential review and written comments. (Contact the AICPA for further information.)
- .10 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 both changing conditions in the firm and evolving standards of the profession.

Sample Quality Control Document for a Sole Practitioner CPA Firm Without Full-Time Staff

.11 Firm Background Information

My firm was founded in 1968 after I had gained several years' experience with a local CPA firm. A secretary and a student from the local university are employed on a part-time basis during the busy season.

My objective is to provide quality service in accounting, auditing, income tax, and financial advisory capacities to small businesses in my community. I do not serve publicly held companies, nor do I plan to do so. It is anticipated that the firm's future growth will be through expanded service to present clients and the addition of new clients.¹ I intend to hire and train personnel as needed.

My hours and that of my part-time help were as follows for the past calendar year:

	<u>Myself</u>	<u>Staff</u>	<u>Total</u>
Auditing	300	60	360
Unaudited financial statements	400	60	460
Taxes	900	120	1,020
Other accounting services	400	—	400
Total chargeable	<u>2,000</u>	<u>240</u>	<u>2,240</u>
Nonchargeable	400	—	400
Total hours	<u>2,400</u>	<u>240</u>	<u>2,640</u>

My practice is conducted from one office and consists of five audit engagements, for which we are the sole auditors, twelve unaudited financial statement engagements, and fifteen clients for which my firm provides other accounting services. The audit engagements range in time from fifty hours to ninety hours and include three retail establishments and two nonprofit organizations.

May 31, 1978

¹ The objectives stated herein are adapted from the *MAP Handbook*. Additional considerations for establishing a firm's stated objectives are discussed in Appendix A.

.12 Independence

Any part-time staff and I 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. I communicate with the AICPA and/or the (state) CPA Society for assistance, if needed, in resolving independence questions.
- b. A memorandum documenting the resolution of independence questions is prepared and retained. My part-time employee reviews and initials the memorandum if the question relates to his independence.
- c. Accounts receivable that are past due are reviewed monthly to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.
- d. Our library contains professional, regulatory, and firm literature relating to independence matters.²

.13 Assigning Personnel to Engagements

Assignment of 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.

On an annual basis, normally in October of each year, I develop a projection of anticipated manpower requirements to determine if I will need additional staff during the coming year.

.14 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. **A technical reference library is maintained, and I have made arrangements to use the libraries of other practicing CPAs. The AICPA library is also used on a frequent basis.**

² The appropriate information may be found in *AICPA Professional Standards*, vol. 2 (Chicago: Commerce Clearing House), and in rulings and interpretations of the state CPA Societies, the state boards of accountancy, and state statutes.

.16 Hiring

1. **The firm endeavors to obtain qualified personnel and has established qualifications and guidelines for evaluating potential hires.**
 - a. During my busy season, I normally employ a college senior who has completed substantially all of the accounting curriculum course requirements for graduation.
 - b. I interview potential employees and appropriately investigate their backgrounds to reasonably assure our hiring persons with acceptable qualifications.
2. **New personnel are informed of the firm's policies and procedures relevant to them.**

A copy of this quality control document is presented to newly hired personnel.

.17 Professional Development

1. **I have an annual professional development requirement.**
 - a. I am a member of the AICPA and the (state) CPA Society and participate in professional activities.
 - b. I complete a minimum of forty hours of formal continuing professional education each year in areas related to my practice. A record of professional development hours is maintained, updated, and periodically reviewed. The types of programs qualifying for the fulfillment of the forty-hour requirement include—
 - (i) Continuing professional education programs of the AICPA and the (state) CPA Society. These include sessions attended and, with written evidence of completion, cassette/workbook, or workbook programs.
 - (ii) College courses related to the profession.
2. **Information about current developments in professional technical standards and materials containing the firm's technical policies and procedures are made available to personnel.**

I receive and review statements relating to current developments in accounting and auditing including statements and interpretations issued by the Financial Accounting Standards Board, the AICPA Auditing Standards Executive Committee, and other AICPA technical committees.

3. On-the-job training accounts for a significant part of professional development.

I provide for on-the-job training by discussing with my part-time employee the relationship of his work to the engagement as a whole. Also, during my review of working papers prepared by my part-time employee, I explain the need for any additional work requirements discovered through the review process.

.18 Advancement

The element of advancement is inapplicable because the firm uses only part-time staff.

.19 Acceptance and Continuance of Clients

1. Procedures are established for evaluation of prospective clients and for their acceptance as clients.

- a.* I obtain and review available financial information regarding the prospective client (such as annual and interim financial statements and income tax returns).
- b.* I make inquiries about potential clients to bankers, attorneys, credit services, and others having business relationships with the company.
- c.* I contact predecessor auditors, where applicable, and make inquiries in accordance with generally accepted auditing standards.
- d.* I consider 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 \$2,500 or where the expected man-hour requirement exceeds seventy-five 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)* Audits of firms experiencing change in any of the following: management or ownership, legal counsel, fi-

- financial condition, litigation status, nature of business, or scope of engagement.
- e. I evaluate the firm's independence and ability to adequately serve a potential client. In evaluating the firm's ability, I give consideration 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. I assemble, evaluate, and document the items listed above before making an acceptance decision.
- 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 engagement
 - (iv) Upon the emergence of conditions that would have caused me to reject a client had such conditions existed at the time of the initial acceptance.
 - b. I prepare an annual memorandum documenting the evaluations.

.20 Inspection

- 1. The firm conducts an inspection program regarding its quality control policies and procedures.**

Each year, I evaluate the firm's quality control policies and procedures for compliance with professional standards by use of AICPA and/or (state) Society checklists. This procedure includes a review of administrative, personnel, and engagement

files sufficient to obtain reasonable assurance that quality control policies and procedures are being complied with.

2. **Provision is made for reporting inspection findings and for monitoring actions taken or planned.**

I evaluate inspection findings and recommendations together with suggested corrective actions and prepare and retain a memorandum documenting that the inspection has been performed. Appropriate corrective actions, if any, are taken.

Sample Quality Control Document for a Sole Practitioner CPA Firm With Full-Time Staff

.21 Firm Background Information

The firm was founded in 1972 after the proprietor gained several years' experience with a local CPA firm. Presently, our full-time staff consists of two professional employees and a secretary. One per diem accountant is hired during the busy season. An accounting student and a secretary are available on a part-time basis, as needed.

The firm's objectives are to—

- Provide high-quality accounting, auditing, tax, and management advisory services to growth-oriented companies in our geographic area.
- Serve clients with outstanding business potential and to help each company reach its maximum potential through sound and efficient accounting, financial, and management advice.
- Be actively involved in professional, business, community, and civic affairs.
- Offer close, personalized service on a timely basis.

In order to achieve these goals and objectives, the firm seeks to grow through a combination of expanded service to present clients and the addition of new clients on a regular basis.¹

Total hours billed during the year ending December 31, 1977, were as follows:

Auditing	1,400
Unaudited financial statements	1,950
Taxes	2,200
Other accounting services	1,050
Total hours	<u>6,600</u>

Our practice is conducted from one office, and our audit clientele, for which our firm is the sole auditor, consists of six retail establishments, three manufacturing companies, three service companies, and two nonprofit organizations. In addition, we have twenty-eight un-

¹ The objectives stated herein are adapted from the *AICPA Management of an Accounting Practice Handbook* (New York: AICPA). Additional considerations for establishing a firm's stated objectives are discussed in Appendix A.

audited statements clients and twenty clients for whom we provide other accounting services.

Both of our full-time professional staff members joined our firm upon graduation from college. One of the staff members has been with our firm for four years and the other, for one year.

May 31, 1978

.22 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 statutes.
 - a. Mr. (practitioner) is responsible for resolving questions relating to independence matters and is available to provide guidance when required.
 - b. Mr. (practitioner) 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 Mr. (practitioner); the other firm personnel review and initial the memorandum if the question relates to their independence.
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 statutes are also made available to personnel.
 - b. An independent mental attitude is emphasized during the conduct of engagements.
 - c. I review the current client listing 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.²
3. Compliance with policies and procedures relating to independence is monitored.
 - a. Annually, all staff members are required to complete a questionnaire, indicating 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. Mr. (practitioner) 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 Mr. (practitioner) to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

.23 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 September of each year, Mr. (practitioner) develops a projection containing anticipated manpower requirements for the next year.
 - b. In scheduling assignments, Mr. (practitioner) strives to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization, taking into consideration—
 - (i) Engagement size and complexity
 - (ii) Personnel availability
 - (iii) Special expertise required
 - (iv) Timing of the work to be performed

² The appropriate information may be found in *AICPA Professional Standards*, vol. 2 (Chicago: Commerce Clearing House), and in rulings and interpretations of the state CPA Societies, the state boards of accountancy, and state statutes.

2. Mr. (practitioner) is responsible for assigning personnel to engagements.
 - a. Before the assignment of a professional employee to an engagement, Mr. (practitioner) considers the nature of the engagement, personnel availability, extent of supervision required, and possible independence problems or conflicts of interest.
 - b. To the extent practicable, Mr. (practitioner) attempts to achieve a balance between the need for continuity and for periodic rotation of staff.

.24 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. Certain areas or specialized situations have been identified as requiring consultation because of their nature or complexity. They include the following:
 - (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.
 - c. A technical reference library is maintained, and arrangements have been made to use the libraries of other practicing CPAs. The resources of the AICPA library are drawn upon when needed.
 - d. When expertise is not available within the firm, practice questions and problems are referred by Mr. (practitioner) to a division or group in the AICPA or the (state) CPA Society established to handle technical inquiries.
 - e. 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 Mr. (practitioner).

2. 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 consultation policy memorandum 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.

.25 Supervision

1. All engagements are adequately planned.
 - a. On all annual recurring engagements, the staff accountant reviews with Mr. (practitioner) (or Mr. (practitioner) reviews alone) 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 internal control system
 - (iv) Audit or work program
 - (v) Engagement notes and memorandums
 - (vi) Financial statements and accountant's report
 - (vii) Management letters
 - b. For all engagements (including annual recurring engagements, new engagements, and special engagements), the staff accountant submits to Mr. (practitioner) the following, where applicable, for his written approval, or Mr. (practitioner) prepares, where applicable, the following:
 - (i) Engagement letter
 - (ii) Time budget
 - (iii) Preliminary evaluation of the internal control system
 - (iv) Audit or work program
 - (v) A memorandum stating the special problems, if any, 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 resolved by Mr. (practitioner). 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 prior to issuance of the report.**
 - a. The staff accountant reviews and initials all working papers he did not prepare (excluding those prepared by Mr. (practitioner)).
 - b. Mr. (practitioner) reviews the overall engagement (including his own working papers after waiting at least one day following their preparation) by completing a review checklist.

.26 Hiring

1. **The firm endeavors to obtain qualified personnel by planning for personnel needs and establishing hiring objectives.**
 - a. Mr. (practitioner) annually plans the firm's long-range personnel objectives. Current clientele, anticipated growth, personnel turnover, individual advancement, and retirement are among the criteria considered.
 - b. Mr. (practitioner) makes 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. The following general criteria are considered in hiring decisions:

- (i) Academic background
 - (ii) Personal achievements
 - (iii) Work experience
 - (iv) Personal interests
 - c. 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.
 - d. The backgrounds of potential employees are appropriately investigated to reasonably assure our hiring persons with acceptable qualifications by obtaining completed application forms, college transcripts, personal references, and employment references.
 - e. Potential employees are interviewed by Mr. (practitioner) who informs them about the firm.
- 3. New personnel are informed of the firm's policies and procedures relevant to them.**
- a. Mr. (practitioner) discusses the firm's personnel policies and procedures with new employees.
 - b. A copy of this quality control document is presented to newly hired personnel.

.27 Professional Development

- 1. Guidelines and requirements have been established for the firm's professional development program and are communicated to all personnel.**
- a. Mr. (practitioner) and any eligible staff are members of the AICPA and the (state) CPA Society; they also participate in professional activities.
 - b. Mr. (practitioner) is responsible for the formulation and implementation of guidelines and requirements for professional development.
 - c. As part of their orientation, new employees are informed of professional responsibilities and opportunities by Mr. (practitioner).
 - d. Mr. (practitioner) and the full-time professional employees are required to complete a minimum of forty hours of formal continuing professional education each year. Personnel complete the record-of-professional-development form and forward it to Mr. (practitioner). He reviews the form and has it filed in the individual's personnel file. 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. Mr. (practitioner) annually reviews and approves 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.

It is the responsibility of Mr. (practitioner) 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, the AICPA Auditing Standards Executive Committee, and other AICPA technical committees.

3. The firm recognizes that on-the-job training accounts for a significant part of professional development.

- a. Mr. (practitioner) provides for on-the-job training by discussing with the engagement staff the relationship of the work they are performing to the engagement as a whole. Also, during the review of working papers prepared by staff members, the proprietor explains the need for any additional work requirements discovered through the review process.
- b. When practicable, professional employees are assigned to varying engagement areas.
- c. Assignments are monitored to determine that personnel are fulfilling, where applicable, the experience requirements of the (state) Board of Accountancy.

.28 Advancement

- 1. The performance of our personnel is continuously evaluated, and personnel are periodically advised of their progress. Per-

sonnel files are maintained containing documentation of the evaluation process.

- a. At least annually, all professional employees receive an evaluation of their performance. Such counseling interviews are conducted by Mr. (practitioner). 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.
2. Mr. (practitioner) makes advancement and termination decisions and documents the results.

.29 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 and 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. Where applicable, predecessor auditors 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 \$3,000 or where the expected man-hour requirement exceeds ninety 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) Audits of firms experiencing change in any of the following: management or ownership, legal counsel, financial condition, litigation status, nature of business, or scope of engagement.
 - e. The firm's independence and ability to adequately serve a potential client are evaluated prior to its 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. Mr. (practitioner) assembles, evaluates, and documents the applicable foregoing considerations before making an acceptance decision.
- 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 engagement
 - (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, Mr. (practitioner) makes the continuance decision and documents it with a memorandum.

.30 Inspection

1. **The firm conducts an inspection program regarding its quality control policies and procedures.**

Using AICPA and/or (state) Society checklists, Mr. (practitioner) annually evaluates the firm's quality control policies and procedures for compliance with professional standards. This procedure includes a review of administrative, personnel, and engagement files sufficient to obtain reasonable assurance that quality control policies and procedures are being complied with.

2. **Provision is made for reporting inspection findings and for monitoring actions taken or planned.**

Mr. (practitioner) evaluates the inspection findings and recommendations together with suggested corrective actions and prepares and retains a memorandum documenting that the inspection has been performed. Appropriate corrective actions, if any, are taken.

APPENDIX A

**.31 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 personnel.
4. Growth plans including opening of branch offices, annual billings, and staff size.
5. Development of specialties such as auditing governmental units or concentration in particular fields—agriculture, retail, and so forth.
6. Development of other services such as a computer data processing center.
7. Pattern for firm growth—internal growth through acquisitions of clients and growing apace with them or growth through mergers with other accounting firms.

APPENDIX B

.32 References to Management of an Accounting Practice Handbook

The *AICPA Management of an Accounting Practice Handbook* (New York: AICPA) 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 and one chapter of the *MAP Handbook* (updated through October, 1977) relating to quality control that may be used by sole practitioners. Some of the exhibits could be used intact, while others will require modification for application to a firm's quality control document.

	<u>Reference</u>
Assigning Personnel to Engagements	
Time Budget	205-8
Scheduling Master Plan	205-52
Consultation	
A Suggested Firm Library	ch. 505
Supervision	
Report Guide Sheet	206-1
Standard Office Review Program	206-3
Hiring	
Interview Evaluation	302-3
Professional Employment Application	302-10
Professional Development	
Record of Professional Development	306-1
Advancement	
Performance Evaluation—Audit	307-3
Partner and Principal Self-Evaluation Form	407-1
Acceptance and Continuance of Clients	
Client Review	105-1
New Client Report	204-36
Client Data Sheet	204-37-1

