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1991 ACCOUNTING AND AUDITING
UPDATE HANDBOOK

AICPA

1991
ACCOUNTING
AND
AUDITING
UPDATE HANDBOOK

AICPA
American Institute of Certified Public Accountants

ERRATUM

1991 Accounting and Auditing Update Handbook

The *title* of Chapter 2, "Corporate Financial Reporting in Reorganization Under the Bankruptcy Code," incorrectly references SASs 53 through 61.

The correct title is "Corporate Financial Reporting in Reorganization Under the Bankruptcy Code." There is *no* cross-reference to Statements on Auditing Standards.

1991

ACCOUNTING AND AUDITING

UPDATE HANDBOOK

1991 ACCOUNTING AND AUDITING UPDATE HANDBOOK

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The *Accounting and Auditing Update Handbook* is intended to provide practitioners with nonauthoritative practical assistance concerning accounting and auditing matters. It has not been approved, disapproved, or otherwise acted upon by any committees, the membership, or the governing body of the American Institute of Certified Public Accountants or by the Financial Accounting Standards Board. Therefore, the contents of this study, including the recommendations, are not official pronouncements of either organization.

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Foreword

The *Accounting and Auditing Update Handbook* is a convenient means of keeping up to date on developments in professional standards. It is a relatively compact reference guide to the authoritative pronouncements on accounting and auditing issued within the approximate one-year period before publication—pronouncements on topics that are not yet "mature" and present problems for implementation. It is intended to be a handy reference source for CPAs in both public and private practice.

Many CPA firms prepare internal updating materials for their staffs. The *Accounting and Auditing Update Handbook* can serve as your own firm's updating manual on significant professional developments.

We have monitored professional standards in the following areas:

- Accounting Standards
- Auditing Standards
- Compilation and Review Standards
- Attestation Standards
- Governmental Accounting Standards

All major new pronouncements in these areas within the last year, as well as important projects under consideration, are discussed in this book. The current 1991 edition expands coverage to include an overview of the last *two* years of pronouncements of the Governmental Accounting Standards Board. It now also includes AICPA Accounting and Audit SOPs, Audit Risk Alerts, and an Overview of Proposed Audit and Accounting Guides. It is an indispensable aid in planning and conducting your audits and handling complex current reporting problems.

The update handbook provides in one volume an analysis of recent FASB and GASB Statements and Exposure Drafts, EITFs, Auditing Standards Board SASs, and Exposure Drafts, AICPA Accounting and Auditing Statements of Position, Technical Practice

Aids, SEC Staff Accounting Bulletins, Practice Bulletins, Audit Risk Alerts, Statements on Standards for Attestation Engagements, an overview of Audit and Accounting Guides, and much more. It is your complete guide to new and proposed regulations in 1991.

The discussion of pronouncements explains the basic requirements and attempts to anticipate the issues that will arise as the pronouncements are implemented. The raw material for this book is partially based on the two-day AICPA continuing professional education course—Accounting and Auditing Update Workshop (AAUW). AAUW is presented by state societies of CPAs around the country and attended by thousands of CPAs. We have attempted to incorporate the comments, suggestions, and practice issues raised by course participants into the book.

This edition of the *Update Handbook* covers the following topics:

Chapter 1: Financial Instruments

- Disclosures of information about financial instruments with off-balance-sheet risk and financial instruments, with concentration of risk; SFAS No. 105
- Financial instruments and the off-balance-sheet financing issues project
- Overview of emerging issues regarding selected financial instruments

Chapter 2: Corporate Financial Reporting in Reorganization Under the Bankruptcy Code (SASs 53 Through 61)

- Financial reporting during reorganization proceedings
- Financial reporting when entities emerge from Chapter 11 reorganization
- Continuing entity
- Illustration of fresh-start reporting

Chapter 3: Accounting for Income Taxes (SFAS 96)

- Explanation of SFAS 96 in conformity with steps in computing and reporting current and deferred income taxes
- Shortcutting the scheduling process

- Selected recommendations from *A Guide to Implementation of Statement 96 on Accounting for Income Taxes*
- Comprehensive applications on scheduling and computing deferred income taxes, accounting for NOLs, and computing the effects of a change in tax rules

Chapter 4: GASB Statements

- Reporting cash flow for proprietary and nonexpendable trust funds and governmental entities that use proprietary accounting, GASB Statement No. 9
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- Measurement focus and basis of accounting—governmental fund operating statements, GASB Statement No. 11
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Chapter 5: FASB Exposure Draft

- Employers' accounting for postretirement benefits other than pensions

Chapter 6: The FASB Emerging Issues Task Force

- Overview of selected EITF releases over the last year that have general applicability to nonpublic and small public companies, consideration for implementation issues with example of computerized financial information

Chapter 7: Overview of AICPA Technical Inquiries, Accounting Statements of Position, and Practice Bulletins

- Reviews of guidance of general applicability to nonpublic and small public companies
- Practice bulletin on amortization of discounts on certain loans
- Statement of position on financial accounting by providers of prepaid health care services

Chapter 8: SEC Staff Accounting Bulletins

- Review of SABs issued during the last year that have general applicability for nonpublic companies and form part of GAAP, including

  —Earnings-per-share computations in initial public offerings

  —Quasi-reorganization

  —Contingency disclosures regarding property-casualty

Chapter 9: Controversy Concerning Compilation Services

- Discussion of issues, proposal and resolution of need for new level of services, including

  —New guidance on financial statements versus trial balance, submitting draft financial statements and submission of financial statements

  —Consider implementation issues with example of computerized financial information

Chapter 10: Audit Risk Alerts

- Overview of 1989 Audit Risk Alert identifying current developments that may affect planning of year-end audits
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- New auditing procedures studies
- 1990 professional ethics pronouncements
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- Notices to practitioners

Keeping up with the developments in professional standards on a current basis is an almost impossible task for many busy professionals. This book is intended to ease the burden by summarizing those accounting and auditing pronouncements issued within the last two years.

Acknowledgments

We would like to express our gratitude to all those who helped in the preparation of the *Accounting and Auditing Update Handbook*. In particular we thank Paul Pacter, CPA, PhD, Professor of Accounting, University of Connecticut, Kurt Pany, CPA, Arthur Andersen/Don Dupont Professor of Accounting, Arizona State University at Tempe and Steven Rubin, CPA, Director of Quality Control, Weissbarth, Altman & Michaelson, CPAs, Adjunct Assistant Professor of Accounting, Brooklyn College, City University of New York, who reviewed the text of this volume.

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CHAPTER 1
Financial Instruments

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Financial Instruments

In this chapter we review the status of the Financial Accounting Standards Board (FASB) project on financial instruments and then review the new guidance on disclosures about financial instruments required under Statement of Financial Accounting Standards (SFAS) 105, *Disclosures of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentration of Credit Risk*. We conclude with an overview of selected Emerging Issue Task Force issues related to financial instruments. Appendix A presents an article entitled "The Challenges of Hedge Accounting," which appeared in the November 1989 issue of the *Journal of Accountancy* and which shows how the explosion of new hedging instruments has outpaced accounting guidance.

FINANCIAL INSTRUMENTS AND OFF-BALANCE-SHEET FINANCING ISSUES PROJECT

In May 1986, the Board added a project on financial instruments to its agenda. A task force was appointed in May 1989 to advise the Board on aspects of the project. The FASB is addressing accounting issues in three separate but related phases: disclosure, recognition and measurement, and distinguishment between liabilities and equity. The project is intended to develop broad standards aiding in resolving the numerous issues encountered from inconsistent practices and diversity in reporting guidance.

Disclosure

In November 1987, the FASB issued an exposure draft, *Disclosures About Financial Instruments*, that called for disclosures about credit risk, market risk, future cash receipts and payments, market risk, and market value of all financial instruments. Based on comments, this phase ultimately resulted in the March 1990 release of SFAS 105, *Disclosure of Information About Off-Balance-Sheet Risk and Financial Instruments with Concentration of Risk*. The next phase of the disclosure project focuses on disclosures about market value, which will be addressed by an exposure draft planned for fourth quarter 1990.

Recognition and Measurement

The FASB intends to address the following types of situations in the recognition and measurement phases:

- Should financial assets be considered sold if they are sold with recourse or if the seller has continuing involvement with them?
- Should financial liabilities be considered settled when assets are dedicated to settle them?
- What are conditions for derecognition, nonrecognition, and offsetting of related financial assets and liabilities?
- What is the appropriate accounting for financial instruments and transactions intended to transfer market risk and credit risk and for the underlying assets or liabilities for which the risk is being transferred? (Such arrangements include futures contracts, interest rate swaps, options, forward commitments guarantees, and nonrecourse arrangements.)
- Should financial instruments be measured at market value, amortized original cost, or lower of cost or market?

In 1991 the FASB is scheduled to release a discussion memorandum that sets forth objectives, scope, and methodology for dealing with recognition and measurement issues. The memorandum will include alternative solutions to some basic representative financial instruments, which can lead to solutions for more complex instruments. The Board is also working on hedge accounting issues, which may also be included in the discussion memorandum.

The Board, in developing the framework, has tentatively identified six fundamental financial instruments.

1. Unconditional Receivable (Payable). An unqualified right (obligation) to receive (deliver) cash or another financial asset on or before a specified date or on demand. These contracts entail a future one-way transfer of one or more financial assets. Examples are trade accounts, notes, loans, and bonds receivable (payable).

2. *Conditional Receivable (Payable).* A right (obligation) to receive (deliver) cash or another financial asset dependent on the occurrence of an event beyond the control of either party to the contract. These contracts entail a potential one-way transfer of one or more assets. Examples include interest rate caps and floors, insurance contracts without subrogation rights, and compensation promised to a third party if a transaction or other event occurs.

3. *Forward Contract.* An unconditional right and obligation to exchange financial instruments. Examples include forward purchase and sale contracts, futures contracts, and repurchase agreements that obligate both parties to a future exchange of financial instruments. (Forward and futures contracts for the purchase or sale of metals, grain, or other goods do not qualify as financial instruments because the items to be exchanged are not both financial instruments.)

4. *Option.* A right (obligation) to exchange other financial instruments on potentially favorable (unfavorable) terms that is conditional on the occurrence of an event within the control of one party to the contract. Most commonly, the conditional event is an option holder's decision to exercise the right to demand the exchange. Examples include warrants, loan commitments, and exchange-traded and other put or call options. Bonds or stocks with attached warrants, mortgages that allow the borrower to prepay, and convertible bonds are examples of compound financial instruments containing options.

5. *Guarantee or Other Conditional Exchange.* A right (obligations) to exchange financial instruments on potentially favorable (unfavorable) terms that is conditional on the occurrence of an event outside the control of either party. Examples include performance bonds, letters of credit, and all other contracts for which the obligor, on occurrence of a specified event, would receive the subrogation or other rights to another financial instrument in exchange for its delivery of a financial instrument.

6. *Equity Instrument.* An ownership interest in an equity. It typically entitles its holder to a pro rata share of any distributions made to that class of holders but only entails a right (obligation) to receive (deliver) cash or other financial instrument assets on the

entity's liquidation. Examples include common stock and partnership interests.

This set of fundamental instruments is being reexamined as the recognition and measurement phase proceeds. Some categories might be combined if analysis shows they should be accounted for similarly, while others might have to be divided.

The Board has reached some tentative conclusions about recognition and measurement issues for unconditional receivables (payables), options, and certain compound instruments (i.e., those not meeting definition of one of the fundamental instruments). These will be presented within the discussion memorandum.

Distinguishing Between Liability and Equity Instruments

The last part of the project will deal with how to distinguish between liability and equity instruments and how to account for financial instruments that have both liability and equity features. Examples of such instruments include convertible debentures and mandatorily redeemable preferred stock. A discussion memorandum is scheduled for issuance in the latter part of 1990. This phase of the project will also include issues related to employee stock compensation.

DISCLOSURE OF INFORMATION ABOUT FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK AND FINANCIAL INSTRUMENTS WITH CONCENTRATIONS OF RISK (SFAS 105)

Scope and Applicability of Guidance

Statement of Financial Accounting Standards 105 applies to financial instruments having off-balance-sheet risk of accounting loss and financial instruments with concentrations of credit risk.

The following instruments are exempt from all disclosure requirements under SFAS 105:

- Insurance contracts other than financial guarantees and investment contracts

- Unconditional purchase obligations
- Employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements
- Financial instruments of a pension plan (including plan assets) when covered by reporting requirements of SFAS No. 87
- Substantially extinguished debt

The following instruments are excluded from disclosure of extent, nature, and terms of financial instruments with off-balance-sheet risk and disclosures of credit risk of financial instruments with off-balance-sheet credit risk, but are subject to disclosures of concentration of credit risk:

- Lease contracts
- Accounts and notes payable and other financial instrument obligations that result in accruals or other amounts that are denominated in foreign currencies and included at translated or remeasured amounts in the balance sheet

However, obligations from financial instruments having other risks in addition to foreign currency exchange risk and obligations under foreign currency exchange contracts are not exempt. Thus, commitments to lend foreign currency, options to exchange foreign currency, forward exchange contracts, currency swaps, foreign currency futures contracts, and options to exchange currencies are not exempt.

Definitions and Examples

Definition of Financial Instrument

The definition of *financial instrument* adopted within the statement is—

> A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both
>
> a. Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity.

b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms.

There are necessarily at least two parties to every financial instrument: the reporting entity and one or more other entities (known as counterparties).

Occurrence of Specified Events. Contractual rights and obligations include those conditioned on occurrence of specified events as well as those not so conditioned. Financial instruments may meet the definitions of assets and liabilities as specified within SFAS Concepts Statement 6, *Elements of Financial Statements*, but not every instrument necessarily meets requirements for recognition as an asset or liability. Hence, some financial instruments are said to be on-balance-sheet, while others are said to be off-balance-sheet.

Chain of Contractual Rights and Obligations. A chain of contractual rights or obligations ending with the receipt or payment of cash or an ownership interest is a financial instrument.

Application of Definition

Cash. The term *cash* includes U.S. dollars and foreign currencies.

Demand Deposits. A demand deposit is a financial instrument, since it is a right of a depositor to receive currency on demand and an obligation of a bank to deliver currency on demand.

Contractual Rights to Receive or Deliver Cash. Accounts receivable, notes, loans, and investments in bonds are contractual rights to receive cash and contractual obligations of another entity to pay cash. Similarly, accounts payable, notes, loans, and bonds payable are contractual obligations to pay cash with a corresponding right of another entity to receive cash.

Although nonmonetary assets, such as inventory, can eventually lead to receipt of cash, they are not financial instruments since no entity has an existing obligation to pay or to receive cash for them.

Contractual Rights to Receive or Deliver Another Financial Instrument. A note requiring as payment in full the delivery of a Treasury bill is a financial instrument since it ultimately represents an obligation of the U.S. Treasury to pay cash.

Contractual Rights or Obligations to Exchange Other Financial Instruments. A call option giving the holder the right to purchase Treasury bills for $200,000 in six months qualifies as a financial instrument. This is so because, on one hand, the holder has the contractual right to exercise the option under favorable terms should the price exceed $200,000 in six months, while, on the other hand, the writer has the contractual obligation to sell the bills on potentially unfavorable terms should the price exceed $200,000.

To illustrate further, an entity enters into a forward contract requiring the acquisition of $200,000 in Treasury notes for cash six months from today. This exchange becomes favorable to the purchaser when the price of the Treasury notes exceeds $200,000 and unfavorable if they fall below $200,000 after six months. Thus, the forward contract can be viewed as either contractual obligations or contractual rights depending on whether the price of the Treasury notes makes the exchange of financial instruments on unfavorable or favorable terms. This forward contract similarly is a financial instrument. Interest rate swaps are similar to a series of forward contracts and are financial instruments. But the sale of a contract for delivery of wheat for $100,000 within three months is not a financial instrument, since the contract is an exchange for a physical asset, not for cash or another financial instrument.

Contingent Rights and Obligations. A guarantee of notes in exchange for a fee is a financial instrument for the guarantor, since there is a contractual obligation to pay cash to the lender if the borrower defaults. But contingent liability to pay damages on a court action is not a financial instrument, since there is no contractual obligation to pay. If, however, the suit is lost and there is a contractual agreement calling for payments, this then constitutes a financial instrument.

Definition of Accounting Loss

Accounting losses are losses that are directly attributable to credit and market risk resulting from rights and obligations of financial instruments. A third component of accounting loss is risk of theft or physical loss, which is not covered by SFAS 105. Economic losses also are not covered by SFAS 105.

Components of Accounting Loss. Credit risk is the possibility, no matter how remote, of failure to perform according to contractual terms. Market risk is the possibility, no matter how remote, that market rate (price changes) may make the instrument more or less valuable.

Off-Balance-Sheet Risk. SFAS 105 focuses on off-balance-sheet risk of accounting loss (the risk of accounting loss that exceeds amounts currently recognized on the balance sheet). For instance, assets such as interest rate swap contracts can expose the firm to conditional rights and obligations exceeding amounts on the books. There may be an agreement calling for settlement resulting in receipts or payments of cash reflecting future changes in interest rates. Liabilities on the balance sheet may expose the entity to accounting loss for potential obligations in excess of amounts on the books. Financial guarantees on debt are examples of such off-balance-sheet risks. In some instances, neither an asset nor a liability appears on the books, such as forward interest agreements. Those financial instruments carried as assets at present values of cash flows or amortized costs are not exposed to accounting loss, since the amounts on the books reflect the exposure.

Examples of Financial Instruments with Off-Balance-Sheet Risk. Exhibit 1-1, taken from SFAS 105, provides examples of financial instruments that do and do not have off-balance-sheet risk. The extent of off-balance-sheet risk for identical instruments may differ between entities because the entities may be subject to different reporting requirements. This exhibit shows that certain financial instruments do not have off-balance-sheet risk to either the holder or issuer: time deposits, bonds at amortized cost or market, accounts or notes payable, collateralized mortgage obligations, fixed and variable rate loans, and accrued receivables and payables. Financial instruments with off-balance-sheet risk to the issuer and not to the holder include repurchase agreements accounted for as sale by issuer, transfer of receivables accounted for as sales with recourse to issuer, financial guarantees, and fixed and variable rate loan commitments. Financial instruments with off-balance-sheet risk to both issuer and holder include interest rate swaps (accrual basis) and financial futures contracts (hedges and nonhedges).

Exhibit 1-1

	Off-Balance-Sheet (OBS) Risk of Accounting Loss					
	Holder[a]			*Issuer*[b]		
		Type of OBS Risk[c]		*Type of OBS Risk*[c]		
Financial Instrument	*OBS Risk*[d]	*CR*	*MR*	*OBS Risk*[d]	*CR*	*MR*
Traditional items:						
Cash	No					
Foreign currency	No					
Time deposits (non-interest-bearing, fixed rate, or variable rate)	No			No		
Bonds carried at amortized cost (fixed or variable rate bonds, with or without a cap)	No			No		
Bonds carried at market (in trading accounts, fixed or variable rate bonds, with or without a cap)	No			No		
Convertible bonds (convertible into stock of the issuer at a specified price at option of the holder; callable at a premium to face at option of the issuer)	No			No		
Accounts and notes receivable/payable (non-interest-bearing, fixed rate, or variable rate)	No			No		
Loans (fixed or variable rate, with or without a cap)	No			No		
Refundable (margin) deposits	No			No		
Accrued expenses receivable/payable (wages, etc.)	No			No		
Common stock (equity investments—cost method or equity method)[e]	No			No		

(continued)

Exhibit 1-1 ***(cont.)***

	Off-Balance-Sheet (OBS) Risk of Accounting Loss					
	Holder[a]			Issuer[b]		
		Type of OBS Risk[c]			Type of OBS Risk[c]	
Financial Instrument	*OBS Risk*[d]	*CR*	*MR*	*OBS Risk*[d]	*CR*	*MR*
Preferred stock (convertible or participating)	No			No		
Preferred stock (nonconvertible or nonparticipating)	No			No		
Cash dividends declared	No			No		
Obligations arising from financial instruments sold short	No			Yes	X	
Innovative items:						
Increasing rate debt	No			No		
Variable coupon redeemable notes	No			No		
Collateralized mortgage obligations (CMOs):						
CMO accounted for as a borrowing by issuer	No			No		
CMO accounted for as a sale by issuer	No			No[f]		
Transfer of receivables:						
Investor has recourse to the issuer at or below the receivable carrying amount—accounted for as a borrowing by issuer.	No			No		
Investor has recourse to the issuer—accounted for as a sale by issuer.	No			Yes	X	
Investor has recourse to the issuer and the agreement includes a floating interest rate provision—accounted for as a sale by issuer.	No			Yes	X	X

Investor has no recourse to the issuer—accounted for as a sale by issuer.	No	No		
Securitized receivables	Same as transfer of receivables			
(Reverse) Repurchase agreements:				
Accounted for as a borrowing by issuer	No	No		
Accounted for as a sale by issuer	No	Yes	X	X
Put option on stock (premium paid up front):				
Covered option	No	Yes		X
Naked option	No	Yes		X
Put option on interest rate contracts[g] (premium paid up front):				
Covered option	No	Yes	X	X
Naked option	No	Yes	X	X
Call option on stock, foreign currency, or interest rate contracts (premium paid up front):				
Covered option	No	Yes		X
Naked option	No	Yes		X
Loan commitments:				
Fixed rate	No	Yes	X	X
Variable rate	No	Yes	X	
Interest rate caps	No	Yes		X
Interest rate floors	No	Yes		X
Financial guarantees	No	Yes	X	
Note issuance facilities at floating rates	No	Yes	X	
Letters of credit (also standby letters of credit) at floating rates	No	Yes	X	

(continued)

Exhibit 1-1 (*cont.*)

	Off-Balance-Sheet Risk of Accounting Loss		
	Both Counterparties[h]		
		Type of OBS Risk	
Financial Instrument	*OBS Risk*	*CR*	*MR*
Interest rate swaps—accrual basis:			
In a gain position	Yes		X
In a loss position	Yes		X
Gain or loss position netted: right of setoff exists[i]	Yes		X
Interest rate swaps—marked to market:			
In a gain position	Yes		X
In a loss position	Yes		X
Gain or loss position netted: right of setoff exists[i]	Yes		X
Current swaps	Same as interest rate swaps		
Financial futures contracts—hedges (marked to market and gain or loss deferred—Statement 52 or 80 accounting):			
In a gain position	Yes		X
In a loss position	Yes		X
Multiple contracts settled net	Yes		X
Financial futures contracts—nonhedges (marked to market—Statement 52 or 80 accounting):			
In a gain position	Yes		X
In a loss position	Yes		X
Multiple contracts settled net	Yes		X
Forward contracts—hedges (marked to market and gain or loss deferred):			
In a gain position	Yes		X
In a loss position	Yes		X
Gain or loss position netted: right of setoff exists[i]	Yes		X

Forward contracts—nonhedges (marked to market and gain or loss recognized):		
In a gain position	Yes	X
In a loss position	Yes	X
Gain or loss position netted: right of setoff exists[i]	Yes	X
Forward contracts—not marked to market	Yes	X

Note: Credit risk and market risk are present for many of the instruments included in this illustration. However, only those instruments with off-balance-sheet credit or market risk are denoted with an "X" (refer to footnote c).

[a]Holder includes buyer and investor.

[b]Issuer includes seller, borrower, and writer.

[c]An "X" in any of the columns (CR or MR) denotes the presence of the respective *off-balance-sheet* risk of accounting loss. The types of risk included are:

1. *Credit risk* (CR)—the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract.
2. *Market risk* (MR)—the possibility that future changes in market prices may make a financial instrument less valuable or more onerous.

[d]A "Yes" in this column denotes the present of off-balance-sheet risk of accounting loss; a "No" denotes no off-balance-sheet risk of accounting loss.

[e]Many joint ventures or other equity method investments are accompanied by guarantees of the debt of the investee. Debt guarantees of this nature present off-balance-sheet risk of accounting loss due to credit risk and should be evaluated with other financial guarantees.

[f]Issuer refers to both the trust and the sponsor.

[g]Put options on interest rate contracts have credit risk if the underlying instrument that might be put (a particular bond, for example) is subject to credit risk.

[h]Swaps, forwards, and futures are two-sided transactions; therefore, the holder and issuer categories are not applicable. Risks are assessed in terms of the position held by the entity.

[i]Netting of receivable and payable amounts when right of setoff does not exist is in contravention of APB Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7, and FASB Technical Bulletin No. 88-2, *Definition of a Right of Setoff*.

SOURCE: FASB, Statement of Financial Accounting Standards 105, "Disclosure of Information About Financial Instruments With Off-Balance-Sheet Risk and Financial Instruments With Concentrations of Credit Risk" (Norwalk, Conn.: FASB, 1990). Reprinted with permission.

Concentration of Credit Risk

Concentration of credit risk results from exposure with an individual counterparty or with a group of counterparties in the same industry or region or having similar economic characteristics. Risk from concentration can be favorable or unfavorable, but, typically, results from lack of diversification in a portfolio and leads to more risk. Group concentrations exist when a number of counterparties sharing similar economic characteristics or operating in a similar geographic region are affected in a similar manner when changes in economic or other conditions occur. Examples are loans to highly leveraged real estate entities.

Effective Date

SFAS 105 is effective for financial statements issued for fiscal years ending after June 15, 1990. In the transition year, no disclosures are required for earlier comparative years. For all subsequent years, comparative financial instrument disclosures should be provided.

Reporting Requirements

Disclosure of Extent, Nature, and Terms of Financial Instruments with Off-Balance-Sheet Risk

The following information should be disclosed for financial instruments having either off-balance-sheet credit or market risk:

- Face or contract amount (notional principal amount if no face or contract amount)
- Nature and terms of financial instruments including a discussion of credit risk, market risk, cash requirements, and accounting policies for recognizing and measuring those instruments
- Accounting Policies can be described following guidance in APB Opinion No. 22, *Disclosures of Accounting Policies.*

Disclosure of Credit Risk from Financial Instruments with Off-Balance-Sheet Credit Risk

The following information should be disclosed for financial Instruments with off-balance-sheet credit risk:

- Amount of accounting loss that would be incurred if parties failed to perform according to contract and collateral or other security became worthless
- Policies regarding requisite collateral or other support of those instruments subject to credit risk
- Information about firm's access to collateral or security
- Nature and description of collateral and support

Disclosure of Concentrations of Credit Risk

The following information should be disclosed for each significant concentration of credit risk:

- The activity, region, or economic characteristics that provide information about the concentration
- The amount of accounting loss that would be incurred if parties making up the concentration failed to perform according to contractual terms and collateral or other security becomes worthless
- The entity's policies for requiring collateral or other security in support of instruments having credit risk, the means of accessing collateral or other security, and a description of such collateral or other security

The required information can be disclosed either in the body of the financial statements or in the accompanying notes. Other disclosures about financial instruments apart from those required by SFAS 105 are unaffected by the Statement. SFAS 105 amends paragraph 9 of SFAS 77, *Reporting by Transferors for Transfers of Receivables With Recourse*, to require consistent disclosures.

The description of principal activities may be a way to disclose industry and regional concentrations. Retail stores can provide insight into credit risk by describing business, location, and credit granting policies to local customers.

Exhibit 1-2 provides some sample disclosures.

Exhibit 1-2 ***Illustrations Applying the Disclosure Requirements About Financial Instruments With Off-Balance-Sheet Risk and Concentrations of Credit Risk***

Example 1—Nonfinancial Entity

This example illustrates the information that might be disclosed by CDA Corporation, a nonfinancial entity that has entered into interest rate swap agreements and foreign exchange contracts.* CDA Corporation has no significant concentrations of credit risk with any individual counterparty or groups of counterparties.

CDA Corporation might disclose the following:

Note U: Summary of Accounting Policies

[The accounting policies note to the financial statements might include the following.]

Interest Rate Swap Agreements

The differential to be paid or received is accrued as interest rates change and is recognized over the life of the agreements.

Foreign Exchange Contracts

The Corporation enters into foreign exchange contracts as a hedge against foreign accounts payable. Market value gains and losses are recognized, and the resulting credit or debit offsets foreign exchange gains or losses on those payables.

Note V: Interest Rate Swap Agreements**

The Corporation has entered into interest rate swap agreements to reduce the impact of changes in interest rates on its floating rate long-term debt. At December 31, 19XX, the Corporation had outstanding two interest rate swap agreements with commercial banks, having a total notional principal amount of $85 million. Those agreements effectively change the Corpora-

*This example might apply also to a financial entity that has a limited number of financial instruments with off-balance-sheet risk.

**Placement within financial statements of the information that describes the extent of involvement an entity has in financial instruments with off-balance-sheet risk and the related nature, terms, and credit risk of those instruments is at the discretion of management. The example illustrates information that would be provided in a note "Interest Rate Swap Agreements." As an alternative, this same information could be included in the entity's note about long-term financing arrangements.

Exhibit 1-2 ***(cont.)***

tion's interest rate exposure on its $35 million floating rate notes due 1993 to a fixed 12 percent and its $50 million floating rate notes due 1998 to a fixed 12.5 percent. The interest rate swap agreements mature at the time the related notes mature. The Corporation is exposed to credit loss in the event of nonperformance by the other parties to the interest rate swap agreements. However, the Corporation does not anticipate nonperformance by the counterparties.

Note W: Foreign Exchange Contracts

At December 31, 19XX, the Corporation had contracts maturing June 30, 19X1 to purchase $12.9 million in foreign currency (18 million deutsche marks and 5 million Swiss francs at the spot rate on that date).

Example 2—Financial Entity

This example illustrates the information that might be disclosed by Bank of SLA, which has entered into the following financial instruments with off-balance-sheet risk: commitments to extend credit, standby letters of credit and financial guarantees written, interest rate swap agreements, forward and futures contracts, and options and interest rate caps and floors written. Bank of SLA has (a) significant concentrations of credit risk in the semiconductor industry in its home state and (b) loans to companies with unusually high debt to equity ratios as a result of buyout transactions.

Bank of SLA might disclose the following:

Note X: Summary of Accounting Policies

[The accounting policies note to the financial statements might include the following.]

Interest Rate Futures, Options, Caps and Floors, and Forward Contracts

The corporation is party to a variety of interest rate futures, options, caps and floors, and forward contracts in its trading activities and in the management of its interest rate exposure.

Interest rate futures, options, caps and floors, and forward contracts used in trading activities are carried at market value. Realized and unrealized gains and losses are included in trading account profits.

Realized and unrealized gains and losses on interest rate futures, options, caps and floors, and forward contracts designated and effective as hedges of interest rate exposure are deferred and recognized as interest income or interest expense over the lives of the hedged assets or liabilities.

Exhibit 1-2 *(cont.)*

Interest Rate Swap Agreements

The Corporation is an intermediary in the interest rate swap market. It also enters into interest rate swap agreements both as trading instruments and as a means of managing its interest rate exposure.

As an intermediary, the Corporation maintains a portfolio of generally matched offsetting swap agreements. These swaps are carried at market value, with changes in value reflected in noninterest income. At inception of the swap agreements, the portion of the compensation related to credit risk and ongoing servicing is deferred and taken into income over the term of the swap agreements.

Interest rate swap agreements used in trading activities are valued at market. Realized and unrealized gains and losses are included in trading account profits. Unrealized gains are reported as assets, and unrealized losses are reported as liabilities.

The differential to be paid or received on interest rate swap agreements entered into to reduce the impact of changes in interest rates is recognized over the life of the agreements.

Note Y: Financial Instruments With Off-Balance-Sheet Risk*

The Corporation is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit, options written, standby letters of credit and financial guarantees, interest rate caps and floors written, interest rate swaps, and forward and futures contracts. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the statement of financial position. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments.

The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit and financial guarantees written is represented by the contractual notional amount of those instruments. The

*Placement within financial statements of the information that describes the extent of involvement an entity has in financial instruments with off-balance-sheet risk and the related nature, terms, and credit risk of those instruments is at the discretion of management. The example illustrates information that would be provided in a note "Financial Instruments with Off-Balance-Sheet Risk." An entity may decide, however, to disclose this information in several separate notes.

Exhibit 1-2 *(cont.)*

Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. For interest rate caps, floors, and swap transactions, forward and futures contracts, and options written, the contract or notional amounts do not represent exposure to credit loss. The Corporation controls the credit risk of its interest rate swap agreements and forward and futures contracts through credit approvals, limits, and monitoring procedures.

Unless noted otherwise, the Corporation does not require collateral or other security to support financial instruments with credit risk.

	Contract or Notional Amount (in millions)
Financial instruments whose contract amounts represent credit risk:	
Commitments to extend credit	$ 2,780
Standby letters of credit and financial guarantees written	862
Financial instruments whose notional or contract amounts exceed the amount of credit risk:	
Forward and futures contracts	815
Interest rate swap agreements	10,520
Options written and interest rate caps and floors written	950

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Corporation upon extension of credit is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment, and income-producing commercial properties.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. Except for short-term guarantees of $158 million, most guarantees extend for more than five years and expire

Exhibit 1-2 ***(cont.)***

in decreasing amounts through 20XX. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Corporation holds marketable securities as collateral supporting those commitments for which collateral is deemed necessary. The extent of collateral held for those commitments at December 31, 19XX varies from 2 percent to 45 percent; the average amount collateralized is 24 percent.

Forward and futures contracts are contracts for delayed delivery of securities or money market instruments in which the seller agrees to make delivery at a specified future date of a specified instrument, at a specified price or yield. Risks arise from the possible inability of counterparties to meet the terms of their contracts and from movements in securities values and interest rates.

The Corporation enters into a variety of interest rate contracts—including interest rate caps and floors written, interest rate options written, and interest rate swap agreements—in its trading activities and in managing its interest rate exposure. Interest rate caps and floors written by the Corporation enable customers to transfer, modify, or reduce their interest rate risk. Interest rate options are contracts that allow the holder of the option to purchase or sell a financial instrument at a specified price and within a specified period of time from the seller or "writer" of the option. As a writer of options, the Corporation receives a premium at the outset and then bears the risk of an unfavorable change in the price of the financial instrument underlying the option.

Interest rate swap transactions generally involve the exchange of fixed and floating rate interest payment obligations without the exchange of the underlying principal amounts. Though swaps are also used as part of asset and liability management, most of the interest rate swap activity arises when the Corporation acts as an intermediary in arranging interest rate swap transactions for customers. The Corporation typically becomes a principal in the exchange of interest payments between the parties and, therefore, is exposed to loss should one of the parties default. The Corporation minimizes this risk by performing normal credit reviews on its swap customers and minimizes its exposure to the interest rate risk inherent in intermediated swaps by entering into offsetting swap positions that essentially counterbalance each other.

Entering into interest rate swap agreements involves not only the risk of dealing with counterparties and their ability to meet the terms of the contracts but also the interest rate risk associated with unmatched positions. Notional principal amounts often are used to express the volume of these transactions, but the amounts potentially subject to credit risk are much smaller.

Exhibit 1-2 *(cont.)*

Note Z: Significant Group Concentrations of Credit Risk

Most of the Corporation's business activity is with customers located within the state. As of December 31, 19XX, the Corporation's receivables from and guarantees of obligations of companies in the semiconductor industry were $XX million.

As of December 31, 19XX, the Corporation was also creditor for $XX of domestic loans and other receivables from companies with high debt to equity ratios as a result of buyout transactions. The portfolio is well diversified, consisting of XX industries. Generally, the loans are secured by assets or stock. The loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. Credit losses arising from lending transactions with highly leveraged entities compare favorably with the Corporation's credit loss experience on its loan portfolio as a whole. The Corporation's policy for requiring collateral is **[state policy, along with information about the entity's access to that collateral or other security and a description of collateral].**

Example 3—Concentration of Credit Risk for Certain Entities

For certain entities, industry or regional concentrations of credit risk may be disclosed adequately by a description of the business. For example:

a. *A Retailer*—XYZ Corporation is a retailer of family clothing with three stores, all of which are located in Littletown. The Corporation grants credit to customers, substantially all of whom are local residents.

b. *A Bank*—ABC Bank grants agribusiness, commercial, and residential loans to customers throughout the state. Although the Bank has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent upon the agribusiness economic sector.

SOURCE: FASB, Statement of Financial Accounting Standards 105, "Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments With Concentrations of Risk," (Norwalk, Conn.: FASB, 1990). Reprinted with permission.

OVERVIEW OF EMERGING ISSUES—SELECTED FINANCIAL INSTRUMENTS

A review of the Emerging Issues Task Force (EITF) literature as of July 18, 1990 shows that more than sixty-five issues addressed financial instruments or off-balance-sheet financing. Exhibit 1-3 lists the titles of issues. The list is followed by a selective overview of some EITF guidance relating to accounting for debt securities.

Exhibit 1-3 *Emerging Issues Task Force Releases on Financial Instruments and Off-Balance-Sheet Financing*

Financial Instruments

84-3 Convertible debt "sweeteners"
84-5 Sale of marketable securities with a put option
84-7 Termination of interest rate swaps
84-8 Variable stock purchase warrants given by suppliers to customers
84-14 Deferred interest rate setting
84-16 Earnings-per-share cash-yield test for zero coupon bonds
84-36 Interest rate swap transactions
84-40 Long-term debt repayable by a capital stock transaction
85-6 Futures implementation questions
85-9 Revenue recognition on options to purchase stock of another entity
85-17 Accrued interest upon conversion of convertible debt
85-23 Effect of a redemption agreement on carrying value of a security
85-25 Sales of preferred stocks with a put option
85-28 Consolidation issues relating to collateralized mortgage obligations
85-29 Convertible bonds with a premium put
85-30 Sale of marketable securities at a gain with a put option
85-34 Bankers' acceptances and risk participations
85-38 Negative amortizing loans
85-39 Implications of SEC Staff Accounting Bulletin No. 59—"'Noncurrent Marketable Equity Securities"
85-40 Comprehensive review of sales of marketable securities with put arrangements
86-5 Classifying demand notes with repayment terms
86-8 Sale of bad debt recovery rights
86-15 Increasing-rate debt
86-18 Debtor's accounting for modification of debt terms
86-24 Third-party establishment of CMOs
86-25 Offsetting foreign currency swaps
86-26 Using forward commitments as a surrogate for deferred rate setting
86-28 Accounting implications of indexed debt instruments
86-30 Classification of obligations when a violation is waived by the creditor
86-32 Early extinguishment of a subsidiary's mandatorily redeemable preferred stock
86-34 Futures contracts used as hedges of anticipated reverse repurchase transactions
86-35 Debentures with detachable stock purchase warrants
86-40 Investments in open-end mutual funds that invest in U.S. Government securities
86-45 Imputation of dividends on preferred stock redeemable at issuer's option with initial below-market dividend rate

Exhibit 1-3 ***(cont.)***

87-1 Deferral accounting for cash securities that are used to hedge rate or price risk
87-2 Net present value method of valuing speculative foreign exchange contracts
87-12 Foreign debt-for-equity swaps
87-18 Use of zero coupon bonds in a troubled debt restructuring
87-19 Substituted debtors in a troubled debt restructuring
87-20 Offsetting certificates of deposit against high-coupon debt
87-25 Sale of convertible, adjustable-rate mortgages with contingent repayment agreement
87-26 Hedging of foreign currency exposure with a tandem currency
87-30 Sale of a short-term loan made under a long-term credit commitment
87-31 Sale of put options on issuer's stock
88-8 Mortgage swaps
88-9 Put warrants
88-11 Allocation of recorded investment when a loan or part of a loan is sold
88-22 Securitization of credit card portfolios
89-4 Accounting for a purchased investment in a CMO instrument or in a mortgage-backed interest-only certificate
89-5 Sale of mortgage loan servicing rights
89-15 Accounting for a modification of debt terms
89-18 Divestitures of certain investment securities to an unregulated commonly controlled entity under FIRREA
90-2 Exchange of interest-only and principal-only securities for a mortgage-backed security

Off-Balance-Sheet Financing

84-11 Offsetting installment note receivables and bank debt (note monetization)
84-15 Grantor trusts consolidation
84-23 Leveraged buyout holding company debt
84-25 Offsetting nonrecourse debt with sales-type or direct financing lease receivables
84-26 Defeasance of special-purpose borrowings
84-30 Sales of loans to special-purpose entities
84-41 Consolidation of subsidiary after instantaneous in-substance defeasance
84-42 Push-down of parent company debt to a subsidiary
85-11 Use of an employee stock ownership plan in a leveraged buyout
85-16 Leveraged leases
86-36 Invasion of a defeasance trust
87-7 Sale of an asset subject to a lease and nonrecourse financing: wrap lease transactions

Convertible Bonds with a Premium Put

A company issues convertible bonds at par with a premium put that permits the investor to resell the bond back to the issuer at a later date. Since these instruments enable the investor to put back the bonds to the issuer at a premium, the instruments offer a feature that makes them more attractive. In EITF 85-29, *Convertible Bonds with a "Premium Put,"* the Task Force reached a consensus that a liability should be accrued for the put premium over the period from the date of issuance to the initial put date. The consensus also stated that the accrual should continue regardless of changes in market value of debt or underlying common stock. If the put expires unexercised, the accounting depends on the relationship between the put price and the market value of the underlying common stock at the put's expiration date. If the market value of the common stock under conversion exceeds the put price at the time of expiration, additional paid-in capital is credited. When the put price exceeds the market value of the common stock subject to conversion, the put premium is amortized as a yield adjustment over the remaining term of the loan.

Deferred Interest-Rate Setting

In EITF 84-14, *Deferred Interest-Rate Setting*, the Task Force considered a situation in which a borrower issued debt at a fixed rate, and immediately entered into a deferred interest-rate setting arrangement with an investment banker. The agreement called for a setting of the actual interest rate at a future date selected by the banker. If interest rates rise, the debtor will pay the investment banker the present value of the difference in cash payments over the life of the debt. If rates fall, the investment banker will have to make up the difference in differential interest rates.

The accounting issue addressed by the EITF is whether the one-time payment is spread over the term of the debt as an adjustment to interest expense or recognized in income immediately. The Task Force reached a consensus that deferred interest adjustments are an integral part of the original issuance of the debt and should be recognized as an adjustment to interest yield over the term of the debt.

Fixed Debt with Forward Commitment

A similar situation arises when debt is issued with a forward commitment. At issuance of the fixed debt, the borrower simultaneously enters into a forward commitment to purchase long-term Treasury bonds with terms equivalent to those of the debt. If rates fall, the forward commitment is settled at a gain. If rates rise, there is a loss. The forward commitment resembles the deferred interest rate agreement addressed in EITF 84-14.

This issue was discussed by the Task Force in EITF 86-26, *Using Forward Commitments as a Surrogate for Deferred Rate Setting*. No consensus was reached. However, a Task Force majority believed the forward commitment should be treated as a separate transaction. Gains and losses were not to be amortized over the term of the debt. This solution differs from the consensus reached for debt with deferred interest rate setting.

Foregone Accrued Interest upon Conversion of Convertible Debt

Some convertible debt instruments provide that upon conversion of debt into equity, the accrued interest at date of conversion is forfeited by the former debtholder. For example, upon conversion of a zero coupon convertible instrument, investors forego all accrued and unpaid interest. Another example is when the conversion occurs between interest dates.

In EITF 85-17, *Accrued Interest upon Conversion of Convertible Debt*, the Task Force addressed the treatment of the forfeited interest upon conversion of the debt instrument and the question of whether interest expense is to be accrued or imputed to the date of conversion when such forfeiture occurs. The consensus reached was that the issuer should accrue all interest to the date of conversion. Paid-in capital should then be credited for the forfeited accrued interest at the date of conversion, net of tax effects. Accordingly, forfeited interest is treated similarly to the principal amount of the debt converted including any remaining unamortized discount or premium.

Increasing Rate Debt

A borrower issues debt that matures in three months but can be extended at the borrower's option for additional three-month periods up to five years from original issuance. The interest rate increases at a specified amount each time the option to extend is exercised.

In EITF 86-15, *Increasing-Rate Debt,* the Task Force addressed—

- The method of determining interest expense and the maturity date to be used in arriving at the interest rate.
- Classification of debt.
- Period for amortization of debt.
- Treatment of excess interest expense accrual when the interest method is used to determine interest expense and debt is repaid at an earlier than expected maturity date.

The Task Force reached a consensus that interest expense should be determined using an average interest rate based on the expected term of the debt. Ability and intent should be considered in determining the term of the debt. Debt issue costs are amortized over the identical term as used in determining interest cost. Debt should be classified as current or noncurrent depending on the anticipated source of repayment (current assets, new short-term debt, or long-term refinancing) and need not reflect the time frame used to determine periodic interest cost. When debt is repaid prior to expected maturity, the excess interest accrual is an adjustment to interest expense and is not an extraordinary item.

Indexed Debt Instruments

In EITF 86-28, *Accounting Implications of Indexed Debt Instruments,* the Task Force considered accounting issues related to issuance of debt with contingent interest payments in addition to guaranteed interest payments. The contingent payments may be linked to price of specific commodities or to an index such as the S&P 500. In some instances, the right to the contingent payment is detachable from the debt instrument. The accounting issues are—

- Should proceeds be allocated between the debt obligation and investor's right to a contingent payment?
- Accounting for recognition of increases in underlying changes in index or commodity index.

The Task Force consensus was that proceeds should be allocated between the debt obligation and the right if the right to receive a contingent payment was detachable. Any premium or discount resulting from the allocation is to be amortized using the APB Opinion 21, *Interest on Receivables and Payables*. The Task Force was unable to reach a consensus if the right was not detachable.

With regard to the second issue, the Task Force reached a consensus that, as the index increases such that the issuer must make a contingent payment, a liability should be recognized for the difference between the required contingent payment and the amount originally traced to the contingent payment feature. If no amount was attributed to the contingent feature, the fluctuation in index is accounted for as an adjustment in carrying amount of the debt obligation. There is no expectation of changes in index values, and the liability at each balance sheet date is based on the applicable index at that date. Although the appropriateness of hedge accounting to account for changes in the liability was discussed, no consensus was reached.

Modification of Debt Terms When Debtor Is Experiencing Financial Difficulties

A company in financial trouble exchanges debt with the same creditors offering them terms favorable relative to the existing debt outstanding. However, the terms of the new debt are less favorable than would be extended by the creditor on new borrowings on a loan to a firm with a similar credit rating.

In EITF 89-15, *Accounting for a Modification of Debt Terms When the Debtor Is Experiencing Financial Difficulties*, addressed whether the exchange resulted in recognition of a gain under APB Opinion 26, *Early Extinguishment of Debt*. The consensus was that this was not an extinguishment but rather was a modification of an existing obligation to be accounted for under SFAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

Offsetting Installment Note Receivable and Bank Debt

In EITF 84-11, *Offsetting Installment Note Receivable and Bank Debt (Note Monetization)*, a seller receives a note from the buyer on the sale of property. The seller obtains a loan from a bank using the property as collateral, but the bank also has continued recourse to the seller. The seller, however, has a put option allowing transfer of the receivable to the bank in satisfaction of the payable to the bank, making the loan at that point of exercise of the put a nonrecourse borrowing. The issue addressed is whether the liability can be offset against the loan receivable and whether interest income can be offset against interest expense in the seller's financial statement. The consensus was that offsetting was not permitted under the existing accounting literature.

There is subsequent guidance that does not modify this EITF. In SAB 70, offsetting of nonrecourse debt with a related lease receivable is not permitted. Technical Bulletin (TB) 86-2, *Accounting for Interest in the Residual Value of Leased Property*, for instance, indicates that offsetting a lease receivable against nonrecourse debt is appropriate only where a legal right of setoff exists or where the lease is a leveraged lease. In FASB TB 88-2, *Definitions of a Right of Setoff*, the FASB permits the right of setoff if each of two parties owes the other determinable amounts, has the right to setoff, and intends to set off, and the setoff is enforceable by law. Setoff is the debtor's right to discharge debt to another party by applying debt against an amount owed to the debtor by that other party. The aforementioned circumstance is with a third party and so is not addressed by this last TB 88-2.

Violation of Covenant Waived by Creditor

A borrower enters into a long-term loan requiring compliance with covenants at periodic compliance dates (quarterly or semiannual measurement dates). At one of those future compliance dates, there is a violation of the convenant. Although the lender can call the debt, the lender waives the right for a period greater than one year but retains the covenant requirement for future periods.

In EITF 86-30, *Classification of Obligations When a Violation Is Waived by the Creditor*, the Task Force considered whether the waiver is a grace period, and, if so, whether the borrower under SFAS No. 78, *Classification of Obligations That Are Callable by the Creditor*, must classify the debt as current. The consensus is that, unless facts and circumstances indicate to the contrary, the loan could be classified as noncurrent unless (a) there is a covenant violation at the balance sheet date, or (b) without loan modification there would have been such a violation, and (c) it is probable that the borrower will not be able to comply with the covenant at measurement dates within twelve months. Accordingly, if to avoid noncompliance the borrower negotiates a loan modification prior to the balance sheet date and it is probable that the borrower will be in violation of the same or a more restrictive covenant constraint at the next measurement date in three months, the loan is to be classified as current. Similarly, the loan would still be classified as current (a) if the borrower is in violation at the balance sheet and (b) before the issuance of the financial statements, obtains a waiver, and (c) it is again likely the borrower will not meet covenant restrictions at the next measurement date. However, the loan can be classified as current if the borrower is in compliance at the measurement date, but it is probable the borrower will not meet restrictions at the next measurement date within three months.

Sale of Marketable Securities with Put Options

This transaction involves sale by an investor of a marketable security with a put option entitling the buyer to sell the securities back to the seller at a fixed price in the future. In EITF 84-5, *Sale of Marketable Securities With a Put Option*, the Task Force reviewed a case where the seller receives a premium to induce the sale of a marketable security with an option to put the security back to the seller at a future date. The issues addressed are—

- Should the seller account for the transaction as a sale or borrowing?
- How should impairments be recognized?

The Task Force consensus is that the transaction should be based on a probability of whether the put option will be exercised. In making the assessment as to probability of exercise, consideration should be given to price of put, sale price, and duration of put relative to the term of marketable security. Puts that extend beyond one-half the term of the marketable security are considered sale transactions.

The Task Force consensus is that transactions should be accounted for as a borrowing if it is probable that the put will be exercised; otherwise, the transaction should be accounted for as a sale.

Borrowing. In a borrowing transaction, the difference between the put price and proceeds from the sale is treated as interest. Where the transaction is accounted for as a borrowing, there should be continual reassessments of probability of exercise of the put, and a change in circumstances can lead to a change in accounting.

Sale. If it is not probable that the put will be exercised, the transaction is recorded as a sale, and the marketable security is removed from the books of the seller, and a loss is recorded if the carrying value of the marketable securities on the books is greater than proceeds received. Also, any expected losses from a change in the likelihood that the put will be exercised are accrued immediately. There is to be periodic adjustment of the loss accrual.

In EITF 85-30, *Sale of Marketable Securities at a Gain with a Put Option*, the Task Force considered whether EITF 84-5 consensus should apply to sales transactions that would result in a gain. Although no consensus was reached in EITF 85-30, the Task Force reconsidered the issue in EITF 85-40, *Comprehensive Review of Sales of Marketable Securities with Put Arrangements*, and reached a consensus that for sales transactions resulting in gains, the assets should be removed from the books and the gains should be deferred since realization of gain is contingent on whether the put is exercised.

APPENDIX
The Challenges of Hedge Accounting
by John E. Stewart

Increased volatility of interest rates, foreign exchange rates and other prices has elevated hedging to an important business necessity. A tremendous variety of hedging products has sprung up in recent years to meet this need.

How should these products be reported in financial statements? Because traditional guidance fails to answer this question satisfactorily, the challenge of hedge accounting is here. This article describes hedging and why it's important, some of the financial reporting issues involved, the accounting profession's response and the significant problems that exist.

WHAT'S HEDGING AND WHY IS IT IMPORTANT?

Hedging is a tool for transferring price, foreign exchange or interest rate *risk* from those wishing to avoid it to those willing to assume it. Specifically, hedging is the act of taking a position in a hedging instrument—such as in the futures, forward, options or swap market—opposite to an actual position that's exposed to risk. (See Exhibit 1 on page 34 for definitions.) Hedging reduces the risk of loss from adverse price or rate fluctuations that may occur in owning or owing items over a period of time. Conversely, hedging may limit the gain from favorable changes. Among the items hedged are

- Owned assets including financial instruments or commodities such as grains, metals and livestock.

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- Existing liabilities such as foreign currency-denominated borrowings.
- Contractual (firm) commitments to buy or sell items such as commodities or financial instruments.
- Anticipated, but not contractually committed, transactions such as purchases or sales or the issuance or refinancing of debt.

Volatility in interest rates, foreign exchange rates and other prices has created a demand for instruments that could help borrowers, lenders, financial institutions, manufacturers and other industrial companies reduce their risks—risks that if not properly managed could threaten the very survival of their companies. This volatility—combined with increased internationalization, competition, global deregulation, technology, sophisticated analysis techniques and tax and regulatory changes—has promoted an almost unbelievable explosion of innovative financial instruments that may be used as hedging vehicles....

Exhibit 1 ***Definitions of the Basic Hedging Instruments***

Forward. An agreement between two parties to exchange specific items—for example, two currencies—at a specified future date and at a specified price.

Futures. An exchange-traded contract for future delivery of a standardized quantity of an item at a specified future date and at a specified price. Changes in the market value of the futures contract are settled in cash daily.

Option. A contract allowing, but *not* requiring, its holder to buy (call) or sell (put) a specific or standard item at a specified price during a specified time period or on a specified date. Options may trade on exchanges or over-the-counter.

Interest rate swap. An agreement between two parties to exchange one interest stream—for example, floating rate—for another—fixed rate—based on a contractual or notional amount. No principal changes hands.

Currency swap. An exchange of two currencies according to an agreement to re-exchange the currencies at the same rate at a specified future date. During the term of the agreement, exchanges of interest payments denominated in the respective currencies also may occur.

WHY THE NEED FOR HEDGE ACCOUNTING?

The need for some special accounting for hedges arises in part because of our historical cost, transaction-based accounting system. Under that system, the effects of price or interest rate changes on many existing assets and liabilities aren't recognized in income until realized in a later transaction. If the gains or losses on the underlying assets or liabilities are reported in a time period different from that of the losses and gains reported on the instruments used to hedge these assets and liabilities, the accounting result could be reporting related, offsetting accounts in income during different reporting periods. This reporting would tend to cause fluctuations in income, implying increased exposure to price or interest rate changes when, in fact, the exposure has been reduced.

A somewhat similar result would occur if gains or losses were recognized currently for instruments entered into to hedge firmly committed or probable transactions *not* involving existing assets or liabilities. Under traditional accounting, the unrealized gains or losses associated with these future transactions may not be reflected in the financial statements until realized.

The accounting challenges are to develop special or different accounting (hedge accounting) that addresses these issues and then to specify the conditions under which this hedge accounting is appropriate.

THE FASB's RESPONSE

How have accounting standard setters, primarily the Financial Accounting Standards Board, responded to the challenge? In general, the standard setters' response has been slow, ad hoc and inconsistent; but there's some hope in the long run with the FASB's financial instruments project....

In 1981, the FASB issued SFAS 52, *Foreign Currency Translation*, which deals with hedge accounting for foreign exchange forwards, futures and currency swaps. In 1984, it issued SFAS 80, *Accounting for Futures Contracts*, which addresses all types of exchange-traded futures, except foreign currency.

However, problems persist. *For many of the new instruments and transactions, the problem is a total absence of accounting guidance.* Not covered are

- Interest rate forwards.
- Almost all types of options.

- Interest rate swaps.

Interest rate swaps were born in the early 1980's and the market has grown to over $1 trillion. The accounting standards say virtually nothing about how either users or market makers should account for these swaps. Similarly, the market for options of all types—exchange-traded and over-the-counter—on commodities, foreign currencies, financial instruments and futures contracts has soared in recent years, but existing accounting standards address only accounting for options on common stocks SFAS 12, *Accounting for Certain Marketable Securities*).

A second problem is that the standards promulgated are *inconsistent*. To the extent instruments covered by existing standards seem analogous to the new financial instruments, the inconsistencies create uncertainty about which rules to follow.

WHAT'S HEDGE ACCOUNTING?

Both SFAS 52 and 80 provide for hedge accounting. The underlying broad concept of both statements is to achieve some sort of symmetry between accounting for the hedging instrument and the assets, liabilities or transactions being hedged. If specified criteria are met (reduction of risk, designation, effectiveness and so forth), gains or losses on the hedging instrument are recorded at the same time and in the same manner as the losses or gains on the hedged item. If the losses or gains on the item being hedged are *deferred*—for example, assets carried at cost or a future transaction—then the gains or losses on the hedging instrument are *deferred* as part of the carrying amount of the hedged item rather than recognized currently in income.

Similarly, if unrealized changes in the market price of the hedged item are included in income or in a separate component of stockholders' equity (for example, net investment in a foreign entity), gains or losses on the hedging instrument also are recognized as they occur in income or in the separate component of stockholders' equity—thus providing a match.

If the hedging instrument doesn't meet the specified criteria for hedge accounting, it's accounted for separately at value with gains and losses recorded currently in income.

Despite the similarities in concept between SFASs 52 and 80, important inconsistencies exist. These inconsistencies relate both to the conditions necessary to qualify for hedge accounting and the application of hedge accounting when the criteria actually are met.

Exhibit 2 ***Hedge Accounting Comparison***

	SFAS 52[1]	*SFAS 80*[2]	*AICPA Issues Paper on Options*[3]	*Interest Rate Swaps in Practice*[4]
Hedge Accounting Criteria:				
Designation as a hedge	Yes	Yes	Yes	Frequently but not always
Risk reduction basis	Transaction	Enterprise	Transaction	Sometimes
Degree of correlation	Not explicit	High	High	Matching
Ongoing assessment	Not explicit	Yes	Yes	Usually
Hedge of anticipated transaction (not firm commitment)	No	Yes	Yes	Yes
Cross hedges	Usually not	Yes	Yes	Yes
Hedge of an asset carried at cost	N/A	Yes	No	Yes
Application of Accounting:				
Split accounting for inherent elements (premium or discount)	Yes	Usually not	Yes	Frequently not necessary
Amortization of premium or hedge of net investment in a foreign entity	Income or equity	N/A	Income	N/A
Cap on deferred losses to fair value	No	No	Yes	No
Accounting if hedge criteria not met	Formula value	Market	Market	Market or lower of cost or market

[1]SFAS 52 covers foreign exchange forwards, futures and swaps—but not options explicitly.

[2]SFAS 80 covers all (and only) exchange-traded futures except foreign currency futures, which are covered by SFAS 52.

[3]The recommendations included in the AICPA issues paper cover all options (whether or not exchange traded). These recommendations do *not* constitute authoritative generally accepted accounting principles. The chart covers only purchased options.

[4]There's no authoritative GAAP for interest rate swaps, although the emerging issues task force has dealt with several swap issues. Existing practice for interest rate swaps is not uniform. Summarized here is the author's perception of practice. The federal banking regulators are working on a release that would provide guidance for regulatory accounting.

CONFLICTS BETWEEN SFAS 52 AND 80

Exhibit 2 on page 37 compares the provisions of SFASs 52 and 80 in several key areas. Also included are comparisons with the advisory conclusions in the American Institute of CPAs issues paper, *Accounting for Options,* and interest rate swap accounting as applied in practice. It's apparent many conflicts exist, some of which are discussed below.

Risk Reduction. One criterion for hedge accounting is the hedging instruments must reduce exposure to risk. The statements, however, take different approaches to the determination of risk reduction. SFAS 80 requires an *enterprise approach:* A futures contract should reduce the enterprise's other positions already offset the exposure the futures contract is supposed to hedge, the contract won't qualify for hedge accounting. SFAS 52 provides for a *transaction approach:* Foreign exchange forward contracts or futures need only hedge particular transactions, even if other positions already offset the exposure.

Hedges of Anticipated Transactions. SFAS 80 allows the designation of futures contracts as an accounting hedge of an anticipated probable transaction (a transaction that an enterprise expects but isn't obligated to carry out in the normal course of business). SFAS 52 forbids designating foreign currency forward and futures contracts as an accounting hedge of an anticipated foreign currency transaction.

Cross Hedging. Cross hedging involves hedging an exposure, such as commercial paper, with an instrument whose underlying basis differs from the item being hedged, such as U.S. Treasury bill futures. SFAS 80 permits cross hedging if a clear economic relationship exists and high correlation is probable. SFAS 52, however, usually does not permit using one currency to hedge another.

Split Accounting for Inherent Elements (Premium or Discount). Futures and forward contracts incorporate a premium or discount representing the difference between the current spot price of the underlying commodity or instrument and the future or forward price. This difference reflects, among other things, the time value of money. For futures and forward contracts accounted for as hedges, SFAS 52 requires the premium or discount be accounted for separately from the changes in value of the futures or forward contract (split accounting). SFAS 80 forbids separate accounting for the premium or discount except in rare circumstances.

Valuation of Speculative (Nonhedge) Positions. SFAS 80 requires futures positions that don't qualify for hedge accounting to be valued at market value. However, SFAS 52 provides for a formula value that ignores the time value of money. (Note that the FASB's emerging issues task force [EITF] reached a consensus in Issue No. 87-2, *Net Present Value Method of Valuing Speculative Foreign Exchange Contracts*, which says that discounting is allowed but not required in applying SFAS 52.)

FILLING THE VOID

As discussed above, many hedging instruments aren't covered by authoritative generally accepted accounting principles—that is, standards issued by the FASB or its predecessors. To fill the void until the FASB addresses hedge accounting as part of its financial instruments project, accountants have to improvise. They can do this by looking to nonauthoritative guidance and by drawing analogies to existing GAAP. Some of the sources of help and problems in analogizing are described below.

OTHER SOURCES OF INFORMATION

In 1986, the AICPA accounting standards executive committee (AcSEC) finalized an issues paper, *Accounting for Options*, whose conclusions incorporate many of the concepts of SFASs 52 and 80. However, because the SFASs' conclusions are inconsistent, AcSEC had to make choices and developed some new ideas along the way, in some cases *adding* to the inconsistencies. (See JofA, Jan. 87, page 87, for how options work and AcSEC's conclusions.)

The options issues paper has been submitted to the FASB. Although not authoritative, it represents a source of information for practitioners. However, because some of the issues paper's conclusions are inconsistent with existing authoritative literature (for example, SFAS 12), care must be taken in using it.

Other sources of hedge accounting information CPAs may find useful include

- Another AICPA issues paper published in 1980, *Accounting for Forward Placement and Standby Commitments and Interest Rate Futures Contracts*.

Exhibit 3 ***Hedging Issues Dealt with by the Emerging Issues Task Force***

Issue No.	*Topic*
84–7	*Termination of Interest Rate Swaps*
84–14	*Deferred Interest Rate Setting*
84–36	*Interest Rate Swap Transactions*
85–6	*Futures Implementation Questions*
86–25	*Offsetting Foreign Currency Swaps*
86–26	*Using Forward Commitments as a Surrogate for Deferred Rate Setting*
86–28	*Accounting Implications of Indexed Debt Instruments*
86–34	*Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions*
87–1	*Deferral Accounting for Cash Securities That Are Used to Hedge Rate or Price Risk*
87–2	*Net Present Value Method of Valuing Speculative Foreign Exchange Contracts*
87–26	*Hedging of Foreign Currency Exposure with a Tandem Currency*
88–8	*Mortgage Swaps*
88–18	*Sales of Future Revenues*

- Articles describing how hedging products work, the accounting issues and current practice. An example is the article on interest rate swaps in the September 1985 *Journal of Accountancy*... .
- Further, the EITF has dealt with several hedging issues (see Exhibit 3 on page 40), but the solutions sometimes have been ad hoc, and in some cases no consensus was reached.

THE PROBLEMS OF INCONSISTENCIES

Despite the fact that some information exists, the inconsistencies among existing FASB standards, AICPA recommendations and EITF consensus make it difficult to address accounting for new products by analogy. The result is uncertainty about which accounting should be followed. It's particularly difficult and confusing to resolve practice problems because the instruments—futures, forwards, options, swaps and so forth—have similarities. Here are some accounting dilemmas:

What Does a CPA Do with Foreign Currency Options? Does the CPA—

- Follow SFAS 52 and *not* permit hedge accounting for anticipated probable (but not firmly committed) transactions?
- Follow the more recent SFAS 80 and the AICPA option issues paper and permit it?

SFAS 52 does not mention options partially because it was written before options became a factor in the market. And even if anticipatory hedge accounting is acceptable for for foreign currency options, what does the CPA do with instruments such as foreign exchange participating forwards and range forward contracts that have elements of both options and forwards? SFAS 52 clearly prohibits anticipatory hedge accounting for foreign currency forwards, futures and swaps.

What Does the CPA Do with Interest Rate Forwards or Interest Rate Swaps? Does he or she follow—

- The designation and enterprise-risk-reduction criteria of SFAS 80?
- The designation and transaction-risk-reduction criteria of SFAS 52 and the AICPA recommendations?
- None of these?

As indicated in Exhibit 2, practice is not uniform. What about an option on an interest rate swap? What about hedging anticipated, but not firmly committed, transactions with interest rate swaps?

What Does a CPA Do with Synthetic Instruments? Does the CPA—

- Analogize to existing hedge accounting criteria and rules?
- If so, which ones?
- Simply account for the instrument?

Synthetic instruments are created in several ways. For example, an entity issues fixed-rate debt to creditors and at the same time enters into an interest rate swap with a third party. It receives fixed-rate interest and pays floating-rate interest on a notional principal amount that equals the principal on the debt. The combination of the debt and the swap converts fixed-rate debt to "synthetic" floating-rate debt.

Synthetic instrument accounting is accounting for that which the synthetic instrument is meant to replicate—in this case, floating-rate debt. Other examples of synthetic instruments include—

- Callable debt synthetically changed to noncallable debt through writing (selling) an option on an interest rate swap.
- Synthetic putable debt created from callable debt.
- Synthetically shortening the mandatory maturity of callable debt.
- Synthetic yen debt created from dollar-denominated debt and a currency swap.

All of these synthetic instruments behave like basic identifiable financial instruments in the marketplace, but they're created synthetically because the total cost is perceived to be lower. Synthetic instrument accounting is frequently used in practice. Sometimes the same results could be achieved by applying hedge accounting, but in other cases the criteria for hedge accounting aren't satisfied. For example, the synthetic instrument may well *increase* transaction and enterprise risk.

What Does the CPA Do with Hedging Using Cash Instruments? SFAS 52 permits hedge accounting when the *hedging instrument* is a cash instrument, such as foreign currency-denominated debt or time deposits. However, opinions differ about the acceptability of hedge accounting using cash instruments in other areas, such as U.S. government bonds. In Issue No. 87-1, *Deferral Accounting for Cash Securities That Are Used to Hedge Rate or Price Risk*, the EITF did not reach a consensus, although a majority of the EITF members would prohibit hedge accounting in these other areas.

Compounding Problems. Further compounding the problem are some aspects of SFASs 52 and 80 that many believe just don't make sense—that is, they don't follow economic substance:

- The prohibition of anticipatory hedge accounting in SFAS 52.
- The general absence of split accounting for futures in SFAS 80.
- The effective prohibition of cross hedging (tandem currency) in SFAS 52.
- The procedures in SFAS 52 for valuing speculative foreign exchange positions at formula rather than market value.

HOPE FOR RESOLUTION

There's hope for a resolution of these practice problems, but probably not in the near term. That hope is the FASB's project on financial instruments, which includes one segment addressing instruments that transfer risk.

I believe the goals of that project should be to—

- Create a level playing field by developing a conceptually based approach that will account for similar instruments similarly and different instruments differently.
- Achieve accounting consistent with economic substance.
- Modernize and generalize accounting standards to deal with new products.
- Address the needs of both product users and market makers.

Any solution should be able to handle existing instruments as well as instruments that will be developed in the future. Many of the new hedging products will be permutations of existing products.

It's worth noting again that the need for hedge accounting is in part—but not completely—driven by our historical cost system. The more *market value accounting* is used for existing assets and liabilities (and that issue also is part of the FASB's project), the less need for special hedge accounting rules. But until the FASB issues new, comprehensive standards, CPAs will have to solve problems by analogizing to existing literature and current practices and by relying on the EITF.

CHAPTER 2

Corporate Financial Reporting in Reorganization Under the Bankruptcy Code

(SASs 53 Through 61)

CHAPTER 2

Corporate Financial Reporting in Reorganization Under the Bankruptcy Code (SASs 53 Through 61)

SCOPE

In April 1990, the AICPA issued an exposure draft of a proposed Statement of Position (SOP), *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code.* The proposed SOP would promote uniform, realistic financial reporting for entities (1) during reorganization under Chapter 11 of the Bankruptcy Code, and (2) upon emergence from such reorganization. This project was deemed necessary because of the growth in the number of corporate reorganizations under Chapter 11 of the Bankruptcy Code and inconsistencies in accounting practices as a result of a lack of official guidance on financial reporting during and after reorganization.

Reorganization under Chapter 11 is designed to give a debtor entity time to work out agreements with creditors with the help of the Bankruptcy Court so that it will be able to continue operations as a going concern.

Petition

A debtor corporation in a voluntary case enters reorganization and starts the reorganization proceeding by filing a petition with the Bankruptcy Court. The petition ordinarily includes such information as—

- A list of creditors, by class, showing amounts and whether the claim is disputed, contingent, or unliquidated. Claims are classified as priority (wages, taxes, etc.), secured, or partly secured, and unsecured. Also, a list of the twenty largest unsecured creditors must be included.

- A list of equity security holders.
- Schedules of assets and liabilities (detailed balance sheet) as of the date of the petition.
- A statement of financial affairs, which consists of responses to a prescribed list of twenty-one questions designed to give an overall view of the debtor's operations.
- A statement of executory contracts.

The debtor corporation's filing of the petition creates an automatic stay on the actions of creditors, which, in turn, gives the debtor a chance to work out a plan of reorganization.

Plan of Reorganization

The critical element in the proceeding is the development of a plan of reorganization, specifying the treatment of all creditors and equity holders for the approval of the court. Ordinarily, the Bankruptcy Court will confirm a plan if it finds all of the following:

- The plan and the plan proponent have complied with various technical requirements of the Bankruptcy Code.
- Disclosures made in soliciting acceptance of the plan have been adequate.
- Dissenting members of consenting classes of impaired claims would receive under the plan at least the amount they would have received under a Chapter 7 proceeding.
- Claims entitled to priority under the Bankruptcy Code would be paid in cash.
- Confirmation of the plan is not likely to be followed by liquidation or further reorganization.
- At least one class of impaired claims has accepted the plan apart from acceptances of insiders.
- The plan proponent has obtained the consent of all impaired classes of claims or equity securities, or the plan proponent can comply with the cram-down provisions of the Bankruptcy Code. (Under the cram-down provisions, the court may confirm a plan even if one or more classes of impaired claims or equity security holders do not accept it, as long as the court

finds the plan does not discriminate unfairly and is fair and equitable to each nonconsenting class impaired by the plan.)

Creditors and stockholders affected by the plan cannot be solicited without first being given a court-approved disclosure statement. The statement contains information about the following matters:

- Voting rights
- Nature of debtor's operations
- Management after emergence from bankruptcy
- Terms of plan of reorganization
- Reorganization value of the debtor corporation that will emerge from bankruptcy (the reorganization value, which is the fair value of the debtor's assets after restructuring, is the value allocated among the creditors and stockholders and is shown in a pro forma balance sheet)
- Financial information including historical financial statements, especially those showing results of the current year
- Liquidation values

The last item, liquidation value, is important because a bankruptcy court will not approve a plan unless the consideration to be received by each party in interest under the plan exceeds the consideration each party would otherwise receive on liquidation of the entity under Chapter 7 of the Bankruptcy Code.

A confirmed plan's provisions become binding on the parties, discharge the debtor from all preconfirmation claims, and terminate all rights and interests of equity security holders as provided for in the plan.

Application

The proposed SOP would apply to entities that have filed a petition with the Bankruptcy Court and that will reorganize under Chapter 11 and by companies that have emerged from Chapter 11 under confirmed plans.

The proposed SOP would not apply to entities that restructure their debt outside Chapter 11, governmental organizations, or companies that plan to liquidate.

FINANCIAL REPORTING DURING REORGANIZATION PROCEEDINGS

Although generally accepted accounting principles continue to apply in accounting for the transactions of an entity that has entered reorganization, the proposed SOP states that to reflect the entity's evolution during the reorganization proceeding "the financial statements for periods including and subsequent to filing the Chapter 11 petition should distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business" (proposed SOP, par. 22).

Balance Sheet

Distinguishing features of the balance sheet during reorganization are as follows:

Prepetition Liabilities. Prepetition liabilities subject to compromise should be classified separately from prepetition liabilities not subject to compromise, such as fully secured liabilities and postpetition liabilities.

Expected Payments. Liabilities subject to compromise should be reported at the amounts expected to be allowed, even if they may be settled for lesser amounts. This principle also applies to prepetition claims that become known after the petition is filed.

Undersecured Claims. If there is uncertainty about whether a secured claim is undersecured, the entire balance should be classified as a claim subject to compromise, and should remain so classified until the liability is no longer subject to compromise.

Claims Not Estimable. Claims not subject to reasonable estimation should be disclosed in notes in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) 5, *Accounting for Contingencies.*

Debt Discounts or Premiums. Discounts or premiums on debt and debt issue costs should be treated as a valuation of debt. If the net carrying amount of the debt differs from the allowed claims, the net carrying amount should be adjusted and the difference treated as a reorganization gain or loss.

Classification. Liabilities subject to compromise should be classified separately from those that are not subject to compromise. Liabilities not subject to compromise should continue to be classified as current or noncurrent in a classified balance sheet. The categories of liabilities subject to compromise should be disclosed in the notes to the financial statements.

Statement of Operations

Reorganization items, which should be reported separately in the statement of operations, include income and expenses (including professional fees), realized gains and losses, and provisions for losses resulting from the restructuring of the business. This guidance does not apply to discontinued operations reported in accordance with Accounting Principles Board (APB) Opinion No. 30, *Reporting Results of Operations.*

Professional Fees. Professional fees should be expensed as incurred and reported as a reorganization item. Such expenses should not be deferred during the reorganization period.

Interest Expense. Interest expense should be reported as an operating expense only to the extent that interest will be paid during the reorganization period or unless it is probable that the interest will be an allowed claim. The difference between reported and contractual interest should be disclosed.

Interest Income. Interest income attributable solely to the proceeding should be reported as a reorganization item.

Statement of Cash Flows

Reorganization items should be reported separately within each activity in the statement of cash flows. The direct method is preferable to the indirect method for operating items.

Supplementary Combined Financial Statements

When entities in reorganization are consolidated in financial statements that include other entities not in reorganization, condensed combined financial statements of the entities in reorganization should be presented.

Earnings Per Share

Earnings per share should be reported in accordance with APB Opinion No. 15, *Earnings Per Share*. Disclosure should be made if additional shares of common stock or common stock equivalents will be issued, diluting current interests.

Illustrative Financial Statements During Reorganization

Exhibit 2-1, following, presents illustrative financial statements and related disclosures for an entity operating in Chapter 11.

The balance sheet for the debtor-in-possession segregates liabilities not subject to compromise from those that are subject to compromise. A detailed schedule of liabilities subject to compromise is included. In the statement of operations, reorganization items are grouped and shown before "loss before discontinued operations." In the statement of cash flows, items relating to reorganization are clearly identified in operating, investing, and financing activities. Note X describes the debtor's petition for relief under Chapter 11.

FINANCIAL REPORTING WHEN ENTITIES EMERGE FROM CHAPTER 11 REORGANIZATION

An entity that prepares its financial statements under fresh-start reporting would do so at the later of these two dates:

- At the confirmation date, when the entity emerges from reorganization.
- At a later date, when all material conditions precedent to the plan's becoming binding are resolved.

Fresh-Start Reporting

Fresh-start reporting should be adopted only if both of the following conditions are met (proposed SOP, par. 36):

(text continued on page 58)

Exhibit 2-1 ***Illustrative Financial Statements and Footnote Disclosure for an Entity Operating Under Chapter 11***

XYZ Company is a manufacturing concern headquartered in Tennessee with a fiscal year ending on December 31. On January 10, 19X1, XYZ filed a petition for relief under Chapter 11 of the federal bankruptcy laws. The following financial statements (balance sheet and statements of operations and cash flows) are presented as of and for the year ended December 31.

XYZ Company
(Debtor-in-Possession)
Balance Sheet
December 31, 19X1

Assets	*(000s)*
Current assets:	
Cash	$ 110
Accounts receivable, net	300
Inventory	250
Other current assets	30
Total current assets	690
Property, plant and equipment, net	430
Goodwill	210
Total assets	$1,330

The accompanying notes are an integral part of the financial statements.

Reproduced from Proposed Statement of Position, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*, (New York: AICPA, 1990).

Liabilities and Shareholders' Deficit	*(000s)*	
Liabilities not subject to compromise		
Current Liabilities:		
Short term borrowings	$ 25	
Accounts payable—trade	200	
Other liabilities	50	
Total current liabilities	275	
Liabilities subject to compromise	1,100	(a)
Total liabilities	1,375	

Exhibit 2-1 ***(cont.)***

Liabilities and Shareholders' Deficit	*(000s)*
Shareholders' (deficit):	
Preferred stock	325
Common stock	75
Retained earnings (deficit)	(445)
	(45)
Total liabilities & shareholders' (deficit)	$1,330

(a) Liabilities subject to compromise consist of the following:

Secured debt, 14%, secured by first mortgage on building	$ 300,000 (b)
Priority tax claims	50,000
Senior subordinated secured notes, 15%	275,000
Trade and other miscellaneous claims	225,000
Subordinated debentures, 17%	250,000
	$1,100,000

(b) The secured debt in this case should be considered, due to various factors, subject to compromise.

Exhibit 2-1 *(cont.)*

XYZ Company
(Debtor-in-Possession)
Statement of Operations
For the Year Ended December 31, 19X1
(000s)

	19X1
Revenues:	
Sales	$ 2,400
Cost and expenses:	
Cost of goods sold	1,800
Selling, operating and administrative	550
Interest (contractual interest $5)	3
	2,353
Earnings before reorganization items and income tax benefit	47
Reorganization items:	
Loss on disposal of facility	(60)
Professional fees	(50)
Provision for rejected executory contracts	(10)
Interest earned on accumulated cash resulting from Chapter 11 proceeding	1
	(119)
Loss before income tax benefit and discontinued operations	(72)
Income tax benefit	10
Loss before discontinued operations	(62)
Discontinued operations:	
Loss from operations of discontinued products segment	(56)
Net loss	$ (118)
Loss per common share:	
Loss before discontinued operations	$ (.62)
Discontinued operations	(.56)
Net loss	$ (1.18)

The accompanying notes are an integral part of the financial statements.

Exhibit 2-1 *(cont.)*

XYZ Company
(Debtor-in-Possession)
Statement of Cash Flows
For the Year Ended December 31, 19X1
Increase in Cash and Cash Equivalents
(000s)

	19X1
Cash flows from operating activities:	
Cash received from customers	$ 2,220
Cash paid to suppliers and employees	(2,070)
Interest paid	(3)
Net cash provided by operating activities before reorganization items	147
Operating cash flows from reorganization items:	
Interest received on cash accumulated because of the Chapter 11 proceeding	1
Professional fees paid for services rendered in connection with the Chapter 11 proceeding	(50)
Net cash used by reorganization items	(49)
Net cash provided by operating activities	98
Cash flows from investing activities:	
Capital expenditures	(5)
Proceeds from sale of facility due to Chapter 11 proceeding	40
Net cash provided by investing activities	35
Cash flows used by financing activities:	
Net borrowings under short-term credit facility (post petition)	25
Repayment of cash overdraft	(45)
Principal payments on prepetition debt authorized by court	(3)
Net cash provided by financing activities	(23)
Net increase in cash and cash equivalents	110
Cash and cash equivalents overdraft at beginning of year	—
Cash and cash equivalents at end of year	$ 110
Reconciliation of net income to net cash provided by operating activities	
Net loss	$ (118)

Exhibit 2-1 *(cont.)*

	19X1
Adjustments to reconcile net loss to net cash provided by operating activities	
Depreciation	20
Loss on disposal of facility	60
Provision for rejected executory contracts	10
Loss on discontinued operations	56
Increase in postpetition payables and other liabilities	250
Increase in accounts receivable	(180)
Net cash provided by operating activities	$ 98

The accompanying notes are an integral part of the financial statements.

XYZ Company
Notes to Financial Statements
December 31, 19X1

Note X—Petition for Relief Under Chapter 11

On January 10, 19X1, XYZ Company (the "Debtor") filed petitions for relief under Chapter 11 of the federal bankruptcy laws in the United States Bankruptcy Court for the Western District of Tennessee. Under Chapter 11, certain claims against the Debtor in existence prior to the filing of the petitions for relief under the federal bankruptcy laws are stayed while the Debtor continues business operations as debtor-in-possession. These claims are reflected in the December 31, 19X1, balance sheet as "liabilities subject to compromise." Additional claims (liabilities subject to compromise) may arise subsequent to the filing date resulting from rejection of executory contracts, including leases, and from the determination by the court (or agreed to by the parties in interest) of allowed claims for contingencies and other disputed amounts. Claims secured against the Debtor's assets ("secured claims") also are stayed, although the holder of such claims have the right to move the court for relief from the stay. Secured claims are secured primarily by liens on the Debtor's property, plant, and equipment.

The Debtor received approval from the Bankruptcy Court to pay or otherwise honor certain of its prepetition obligations, including employee wages, and product warranties. The Debtor has determined that there is insufficient collateral to cover the interest portion of scheduled payments on its prepetition debt obligations. Contractual interest on those obligations amounts to $5,000, which is $2,000 in excess of reported interest expense; therefore, the Debtor has discontinued accruing interest on these obligations. Refer to Note XX (see Appendix B, Note X) for a discussion of the credit arrangements entered into subsequent to the Chapter 11 filings.

- The reorganization value of the assets of the emerging entity immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims.
- Holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the emerging entity. The loss of control contemplated by the plan must be substantive and not temporary.

Allocation of Reorganization Value

Entities that adopt fresh-start reporting must allocate the reorganization value to specific assets and liabilities.

Assets. An entity should allocate the reorganization value in conformity with the procedures specified for the purchase method in APB Opinion No. 16, *Business Combinations.* If any portion of the reorganization value cannot be attributed to specific tangible or identifiable intangible assets, then the amount should be reported as the intangible asset, "reorganization value in excess of amounts allocable to identifiable assets." The excess should be amortized in accordance with the provisions of APB Opinion No. 17, *Intangible Assets.*

Liabilities. Each liability, other than deferred income taxes, should be stated at its fair value using the principles of accounting for a note issued in a noncash transaction specified in APB Opinion No. 21, *Interest on Receivables and Payables.*

Deferred Income Taxes. The proposed SOP would require that deferred income taxes be reported in conformity with SFAS No. 96, *Accounting for Income Taxes*, or in conformity with APB Opinion No. 11, *Accounting for Income Taxes.* Until SFAS No. 96 supersedes APB Opinion No. 11, the latter standard governs accounting for deferred income taxes. Early adoption of SFAS No. 96 is optional.

NOL Carryforwards. The benefits of existing net operating loss carryforwards would be subsequently recognized by first reducing reorganization value in excess of amounts allocable to identifiable assets, and other intangibles. Then, any balance would reduce income tax expense. The Accounting Standards Executive Committee (AcSEC) and a minority of the task force support that position, because they believe it accords with the model of a purchase business combination used to allocate the reorganization value of the emerging entity.

APB Opinion No. 11 (par. 49), in contrast, requires a retroactive adjustment of the purchase transaction on the subsequent realization of NOL carryforwards in a business combination.

The Financial Accounting Standards Board (FASB), the Securities and Exchange Commission (SEC) staff, and a majority of the task force agree with the proposition that the subsequent realization of NOL carryforwards should first reduce intangibles, but believe that any excess should be reported as a direct contribution to capital. Their view is that it would be inconsistent with the notion of a fresh start to include any benefit in income. The benefits would be used first to reduce any excess reorganization value and then credited directly to contributed capital. This approach is similar to existing requirements covering quasi-reorganization.

The resolution of the divergent viewpoints on the treatment of NOL carryforwards will require a decision on whether a Chapter 11-reorganized (fresh-start) entity is similar to a purchase acquisition or a quasi-reorganization. AcSEC holds that quasi-reorganization accounting literature does not apply to Chapter 11 reorganizations.

Changes in Accounting Principles. Any changes in accounting principles that will be required within twelve months following the adoption of fresh-start reporting should be adopted as of the date fresh-start reporting is adopted.

Retained Earnings or Deficit. Under fresh-start accounting, the entity shows no beginning retained earnings or deficit.

Disclosures. The following disclosures should be made in the notes to the initial financial statements:

- Adjustments to the historical amounts of individual assets and liabilities.
- The amount of debt forgiveness.
- The amount of prior retained earnings or deficit eliminated.
- Significant matters relating to the determination of reorganization value such as—
  - — The method or methods used to determine reorganization value and factors such as discount rates, tax rates, the

number of years for which cash flows are projected, and the method of determining terminal value.

— Sensitive assumptions, such as assumptions about which there is a reasonable possibility of the occurrence of a variation that would have significantly affected measurement or reorganization value.

— Assumption about anticipated conditions that are expected to be different from current conditions, unless apparent.

Comparative Financial Statements. An entity's fresh-start financial statements will not be comparable with its prereorganization statements; therefore, comparative financial statements that straddle a confirmation date should not be presented. However, the effects of the adjustments resulting from fresh-start reporting, as well as the debt forgiveness, should be reflected in the predecessor entity's final statement of operations.

CONTINUING ENTITY

An entity that does not meet the criteria for fresh-start reporting should nevertheless report compromised liabilities in accordance with APB Opinion No. 21, as discussed earlier. The forgiveness of debt, if any, should be reported as an extraordinary item.

The use of quasi-reorganization reporting in such cases is not appropriate.

ILLUSTRATION OF FRESH-START REPORTING AND GLOSSARY

Exhibit 2-2 illustrates fresh-start reporting and the related footnote disclosures. Appendix A presents a glossary of terms reproduced from the proposed SOP.

EFFECTIVE DATE

The proposed SOP would become effective for entities that have filed petitions under the Bankruptcy Code in their fiscal years beginning after December 15, 1990, or that had plans of reorganization confirmed after December 31, 1991. Earlier application by entities in reorganization is encouraged.

Exhibit 2-2 ***Fresh-Start Accounting and Illustrative Notes to Financial Statements***

1B. The Bankruptcy Court confirmed XYZ's plan of reorganization as of June 30, 19X2. It was determined that XYZ's reorganization value computed immediately before June 30, 19X2, the date of plan confirmation, was $1,300,000, which consists of the following:

Cash in excess of normal operating requirements generated by operations	$ 150,000
Net realizable value of asset dispositions	75,000
Present value of discounted cash flows of the emerging entity	1,075,000
Reorganization value	$1,300,000

XYZ Company adopted fresh-start reporting because holders of existing voting shares immediately before filing and confirmation of the plan received less than 50 percent of the voting shares of the emerging entity and its reorganization value is less than its postpetition liabilities and allowed claims, as follows:

Postpetition current liabilities	$ 300,000
Liabilities deferred pursuant to Chapter 11 proceeding	1,100,000
Total postpetition liabilities and allowed claims	1,400,000
Reorganization value	(1,300,000)
Excess of liabilities over reorganization value	$ 100,000

2B. The reorganization value of the XYZ Company was determined in consideration of several factors and by reliance on various valuation methods, including discounting cash flow and price/earnings and other applicable ratios. The factors considered by XYZ Company included the following:

- Forecasted operating and cash flow results which gave effect to the estimated impact of—

Reproduced from Statement of Position, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code" (New York: AICPA, 1990).

Exhibit 2-2 *(cont.)*

- — Corporate restructuring and other operating program changes.
- — Limitations on the use of available net operating loss carryovers and other tax attributes resulting from the plan of reorganization and other events.

- The discounted residual value at the end of the forecast period based on the capitalized cash flows for the last year of that period.
- Market share and position.
- Competition and general economic considerations.
- Projected sales growth.
- Potential profitability.
- Seasonality and working capital requirements.

2C. After consideration of XYZ Company's debt capacity and other capital structure considerations, such as industry norms, projected earnings to fixed charges, earnings before interest and taxes to interest, free cash flow to interest, and free cash flow to debt service and other applicable ratios, and after extensive negotiations, among parties in interest it was agreed that XYZ's reorganized capital structure should be as follows:

Postpetition current liabilities	$ 300,000	
IRS note	50,000	
Senior debt	275,000	(1)
Subordinated debt	175,000	
Common stock	350,000	
	$1,150,000	(2)

(1) Due $50,000 per year for each of the next four years, at 12% interest, with $75,000 due in the fifth year.

(2) See paragraph 2E for the balance sheet adjustments required to reflect XYZ Company's reorganization value as of the date of plan confirmation.

Exhibit 2-2 *(cont.)*

2D. The following entries record the provisions of the plan and the adoption of fresh-start reporting:

Entries to record debt discharge:

Liabilities subject to compromise	1,100,000	
Senior debt—current		50,000
Senior debt—long-term		225,000
IRS note		50,000
Cash		150,000
Subordinated debt		175,000
Common stock (new)		86,000
Additional paid-in capital		215,000
Gain on debt discharge		149,000

Entries to record exchange of stock for stock:

Preferred stock	325,000	
Common stock (old)	75,000	
Common stock (new)		14,000
Additional paid-in capital		386,000

Entries to record the adoption of fresh-start reporting and to eliminate the deficit:

Inventory	50,000	
Property, plant, and equipment	175,000	
Reorganization value in excess of amounts allocable to identifiable assets	175,000	
Gain on debt discharge	149,000	
Additional paid-in capital	351,000	
Goodwill		200,000
Deficit		700,000

2E. The effect of the plan of reorganization on XYZ Company's balance sheet, as of June 30, 19X2, is as follows:

Exhibit 2-2 *(cont.)*

	Pre-confirmation	*Adjustments to Record Confirmation of Plan* Debt Discharge	Exchange of Stock	Fresh Start	XYZ Company's Reorganized Balance Sheet
Assets:					
Current assets:					
Cash	$ 200,000	$ (150,000)			$ 50,000
Receivables	250,000				250,000
Inventory	175,000			$ 50,000	225,00
Assets to be disposed of valued at market which is lower than cost	25,000				25,000
Other current assets	25,000				25,000
	675,000	(150,000)		50,000	575,000
Property, plant, and equipment	175,000			175,000	350,000
Assets to be disposed of valued at market, which is lower than cost	50,000				50,000
Goodwill	200,000			(200,000)	
Reorganization value in excess of amounts allocable to identifiable assets	0			175,000	175,000
	$1,100,000	$ (150,000)		$200,000	$1,150,000

Liabilities and Shareholders' Deficit:					
Liabilities not subject to compromise:					
Current liabilities					
Short-term borrowings	$ 25,000				25,000
Current maturities of senior debt		$ 50,000			50,000
Accounts payable—trade	175,000				175,000
Other liabilities	100,000				100,000
	300,000	50,000			350,000
Liabilities subject to compromise:					
Prepetition liabilities	1,100,000	(1,100,000)			
IRS note		50,000			50,000
Senior debt, less current maturities		225,000			225,000
Subordinated debt		175,000			175,000
Shareholders' deficit:					
Preferred stock	325,000		$(325,000)		0
Additional paid-in capital		215,000	386,000	(351,000)	250,000
Common stock—old	75,000		(75,000)		0
Common stock—new		86,000	14,000		100,000
Retained earnings (deficit)	(700,000)	149,000		700,000	0
				(149,000)	
	(300,000)	450,000	0	200,000	350,000
	$1,100,000	$ (150,000)	$ 0	$200,000	$1,150,000

Exhibit 2-2 *(cont.)*

2F. The following illustrates footnote disclosure, which discusses the details of XYZ Company's confirmed plan of reorganization. In this illustration a tabular presentation entitled "Plan of Reorganization Recovery Analysis" is incorporated in the footnote. The plan of reorganization recovery analysis may alternatively be presented as supplementary information to the financial statements.

Note X. Plan of Reorganization

On June 30, 19X2, the Bankruptcy Court confirmed the Company's plan of reorganization. The confirmed plan provided for the following:

Secured Debt—The Company's $300,000 of secured debt (secured by a first mortgage lien on a building located in Nashville, Tennessee) was exchanged for $150,000 in cash and a $150,000 secured note, payable in annual installments of $27,300 commencing on June 1, 19X3, through June 1, 19X6, with interest at 12% per annum, with the balance due on June 1, 19X7.

Priority Tax Claims—Payroll and withholding taxes of $50,000 are payable in equal annual installments commencing on July 1, 19X3, through July 1, 19X8, with interest at 11% per annum.

Senior Debt—The holders of approximately $275,000 of senior subordinated secured notes received the following instruments in exchange for their notes: (a) $87,000 in new senior secured debt, payable in annual installments of $15,800 commencing on March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plant, and equipment, with the balance due on March 1, 19X7; (b) $123,000 of subordinated debt with interest at 14% per annum due in equal annual installments commencing on October 1, 19X3, through October 1, 19X9, secured by second liens on certain property, plant, and equipment; and (c) 11.4% of the new issue of outstanding voting common stock of the Company.

Trade and Other Miscellaneous Claims—The holders of approximately $225,000 of trade and other miscellaneous claims received the following for their claims: (a) $38,000 in senior secured debt, payable in annual installments of $6,900 commencing March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plant, and equipment, with the balance due on March 1, 19X7; (b) $52,000 of subordinated debt, payable in equal annual installments commencing October 1, 19X3, through October 1, 19X8, with interest at 14% per annum; and (c) 25.7% of the new issue of outstanding voting common stock of the Company.

Exhibit 2-2 *(cont.)*

Subordinated Debentures—The holders of approximately $250,000 of subordinated unsecured debt received, in exchange for the debentures, 48.9% of the new issue of outstanding voting common stock of the Company.

Preferred Stock—The holders of 3,250 shares of preferred stock received 12 percent of the outstanding voting common stock of the new issue of the Company in exchange for their preferred stock.

Common Stock—The holders of approximately 75,000 of outstanding shares of the Company's existing common stock received, in exchange for their shares, 2% of the new outstanding voting common stock of the Company.

The Company accounted for the reorganization using fresh-start accounting. Accordingly, all assets and liabilities are restated to reflect their reorganization value, which approximates fair value at the date of reorganization. The following table ("Plan of Reorganization Recovery Analysis") summarizes the adjustments required to record the reorganization and the issuance of the various securities in connection with the implementation of the plan.

Exhibit 2-2 *(cont.)*

XYZ Company
Plan of Reorganization
Recovery Analysis

		Recovery (†)									
		Elimination of Debt and Equity	*Surviving Debt*	*Cash*	*IRS Note*	*Senior Debt*	*Subordinated Debt*	*Common Stock†* %	*Common Stock†* *Value*	*Total Recovery* $	*Total Recovery* %
Postpetition liabilities	$ 300,000		$300,000							$ 300,000	100%
Claim/Interest											
Secured debt	300,000			$150,000		$150,000				300,000	100
Priority tax claim	50,000				$50,000					50,000	100
Senior debt	275,000	$ (25,000)				87,000	$123,000	11.4	$ 40,000	250,000	91
Trade and other miscellaneous claims	225,000	(45,000)				38,000	52,000	25.7	90,000	180,000	80
Subordinated debentures	250,000	(79,000)						48.9	171,000	171,000	68
	1,100,000										
Preferred stockholders	325,000	(283,000)						12.0	42,000	42,000	
Common stockholders	75,000	(68,000)						2.0	7,000	7,000	
Deficit	(700,000)	700,000									
Total	$1,100,000	$ 200,000	$300,000	$150,000	$50,000	$275,000	$175,000	100%	$350,000	$1,300,000	

†The aggregate par value of the common stock issued under the plan is $100,000.

APPENDIX

Glossary

Absolute priority doctrine. A doctrine that provides that if an impaired class does not vote in favor of a plan, the court may nevertheless confirm the plan under the cram-down provisions of the Code. The absolute priority doctrine is triggered when the cram-down provisions apply. The doctrine states that all members of the senior class of creditors and equity interests must be satisfied in full before the members of the second senior class of creditors can receive anything, and the full satisfaction of that class must occur before the third senior class of creditors may be satisfied, and so on.

Administrative expenses (claims). Claims that receive priority over all other unsecured claims in a bankruptcy case. Administrative claims (expenses) include the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the petition is filed are considered administrative expenses.

Allowed claim(s). The amount allowed by the court as a claim against the estate. This amount may differ from the amount the liability is settled for.

Automatic stay provisions. Provision causing the filing of a petition under the Bankruptcy Code to automatically stay virtually all actions of creditors to collect prepetition debts. As a result of the stay, no party, with minor exceptions, having a security or adverse interest in the debtor's property can take any action that will interfere with the debtor or his property, regardless of where the property is located or who has possession, until the stay is modified or removed.

Bankruptcy Code. A federal statute, enacted October 1, 1979, as title 11 of the United States Code by the Bankruptcy Reform Act of 1978, that applies to all cases filed on or after its enactment and that provides the basis for the current federal bankruptcy system.

Bankruptcy Court. The United States Bankruptcy Court is an adjunct of the United States District Courts. Under the jurisdiction of the District Court, the Bankruptcy Court is generally responsible for cases filed under Chapters 7, 11, 12, and 13 of the Bankruptcy Code.

Chapter 7 proceeding. A liquidation, voluntarily or involuntarily initiated under the provisions of the Bankruptcy Code, that provides for liquidation of the business or debtor's estate.

Chapter 11 proceeding. A reorganization action either voluntarily or involuntarily initiated under the provisions of the Bankruptcy Code that provides for a reorganization of the debt and equity structure of the business and allows the business to continue operations. A debtor may also file a plan of liquidation under Chapter 11.

Claim. As defined by Section 101(4) of the Bankruptcy Code, (a) a right to payment, regardless of whether the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured, or unsecured, or (b) a right to an equitable remedy for breath of performance if such breach results in a right to payment, regardless of whether the right is reduced to a fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured right.

Confirmed plan. An official approval by the court of a plan of reorganization under a Chapter 11 proceeding that makes the plan binding on the debtors and creditors. Before a plan is confirmed, it must satisfy eleven requirements in section 1129(a) of the Bankruptcy Code.

Consenting classes. Classes of creditors or stockholders that approve the proposed plan.

Cram-down provisions. Provisions requiring that for a plan to be confirmed, a class of claims or interests must either accept the plan or not be impaired. However, the Bankruptcy Code allows the Court under certain conditions to confirm a plan even though an impaired class has not accepted the plan. To do so, the plan must not discriminate unfairly and must be fair and equitable, to each class of claims or interests impaired under the plan that have not accepted it. The Code states examples of conditions for secured claims, unsecured claims, and stockholder interests in the fair and equitable requirement.

Debtor-in-possession. Existing management continuing to operate an entity that has filed a petition under Chapter 11. The debtor-in-possession is allowed to operate the business in all Chapter 11 cases unless the court, for cause, authorizes the appointment of a trustee.

Disclosure statement. A written statement containing information approved as adequate by the court. It is required to be presented by a party before soliciting the acceptance or rejection of a plan of reorganization from creditors and stockholders affected by the plan. Adequate information means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class, to make an informed judgment about the plan.

Emerging entity (reorganized entity). An entity that has had its plan confirmed and begins to operate as a new entity.

Impaired claims. In determining which class of creditors' claims or stockholders' interests must approve the plan, it is first necessary to determine if the class is impaired. A class of creditors' claims or stockholders' interests under a plan is not impaired if the plan (a) leaves unaltered the legal, equitable, and contractual right of a class, (b) cures defaults that lead to acceleration of debt or equity interest, or (c) pays in cash the full amount of the claim, or for equity interests, the greater of the fixed liquidation preference or redemption price.

Nonconsenting class. A class of creditors or stockholders that does not approve the proposed plan.

Obligations subject to compromise. Includes all prepetition liabilities (claims) except those that will not be impaired under the plan, such as claims where the value of the security interest is greater than the claim.

Petition. A document filed in a court of bankruptcy, initiating proceedings under the Bankruptcy Code.

Plan (Plan of reorganization). An agreement formulated in Chapter 11 proceedings under the supervision of the Bankruptcy Court that enables the debtor to continue in business. The plan, once confirmed, may affect the rights of undersecured creditors, secured creditors, and stockholders as well as those of unsecured creditors. Before a Plan is confirmed by the court, it must comply with general provisions of the code. Those provisions mandate, for example, that (a) the plan is feasible, (b) the plan is in the best interest of the creditors, and, (c) if an impaired class does not accept the plan, the plan must be determined to be fair and equitable before it can be confirmed.

Postpetition liabilities. Liabilities incurred subsequent to the filing of a petition that are not associated with prebankruptcy events. Thus, these liabilities are not considered prepetition liabilities.

Prepetition liabilities. Liabilities that were incurred by an entity prior to its filing of a petition for protection under the Code, including those considered by the bankruptcy court to be prepetition claims, such as a rejection of a lease for real property.

Reorganization items. Items of income, expense, gain, or loss that are realized or incurred by an entity because it is in reorganization.

Reorganization proceeding. A Chapter 11 case from the time at which the petition is filed until the plan is confirmed.

Reorganization value. The value attributed to the reconstituted entity, as well as the expected net realizable value of those assets that will be disposed before reconstitution occurs. Therefore, this value is viewed as the fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring.

Secured claim. A liability that is secured by collateral. A fully secured claim is one where the value of the collateral is greater than the amount of the claim.

Trustee. A person appointed by the Bankruptcy Court in certain situations based on the facts of the case, not related to the size of the company or the amount of unsecured debt outstanding, at the request of a party in interest after a notice and hearing.

Undersecured liability (claim). A secured claim whose collateral is worth less than the amount of the claim.

Unsecured liability (claim). A liability that is not secured by collateral. In the case of an undersecured creditor, the excess of the secured claim over the value of the collateral is an unsecured claim, unless the debtor elects in a Chapter 11 proceeding to have the entire claim considered secured. The term is generally used in bankruptcy to refer to unsecured claims that do not receive priority under the Bankruptcy Code.

CHAPTER 3

Accounting for Income Taxes
(SFAS 96)

CHAPTER 3

Accounting for Income Taxes (SFAS 96)

OBJECTIVES

This chapter provides guidance on application of the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) 96, *Accounting for Income Taxes*, including—

1. Recognition of a deferred tax liability or asset.
2. Measurement of a deferred tax liability or asset.
3. Accounting for operating loss and tax credit carrybacks and carryforwards.
4. Utilization of tax-planning strategies in accounting for income tax.
5. Allocation of income taxes within financial statements.
6. Preparation of required disclosures.
7. Application of transition requirements.
8. Accounting for alternative minimum tax in determining deferred income taxes.
9. Accounting for a change in tax rates or tax status.
10. Accounting for the tax effects in business combinations.

OVERVIEW

SFAS 96, issued in December 1987, retains the comprehensive allocation objective of Accounting Principles Board (APB) Opinion No. 11, and retains the exceptions in APB 23. However, SFAS 96 replaces the deferred approach with the asset and liability approach. Under the asset and liability approach, deferred taxes are viewed as either assets or liabilities, and accordingly SFAS 96 modifies the accounting for deferred income taxes consistent with that approach.

Tax Jurisdiction—Not Offset. Deferred taxes are computed separately for each taxing jurisdiction, and deferred tax assets and deferred tax liabilities relating to different jurisdictions are not offset.

Changes in Tax Rates or Tax Status. The effects of changes in tax laws, tax rates, or the tax status of an entity are recognized when the law is enacted or when the tax status of the entity changes.

Tax-Planning Effects. Tax-planning strategies are used to reduce a deferred tax liability or increase a deferred tax asset by altering the period in which temporary differences are scheduled to result in taxable income or tax deductions, that is, when they reverse.

Deferred Tax Asset Recognition. Deferred tax assets arising from temporary differences are recognized only to the extent that taxes paid in prior periods or incurred in the current period, including deferred taxes, could be recovered through the use of carrybacks.

Deferred Tax in Business Combinations. Deferred tax assets and liabilities are recognized on temporary differences in business combinations.

Current-Noncurrent Classification. Deferred tax assets and liabilities are classified as current or noncurrent based on the period of reversal rather than on the nature of the transaction giving rise to the temporary difference.

SFAS 96, as amended by SFAS 100, is effective for fiscal years beginning on or after December 15, 1989; however, the Board has decided to further defer the effective date to fiscal years beginning after December 15, 1990.

SUPERSEDED STATEMENTS AND STATEMENTS NOT AMENDED BY SFAS 96

Comprehensive Tax Allocation Continued

SFAS 96, *Accounting for Income Taxes,* establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. SFAS 96 continued the fundamental requirements of comprehensive tax allocation with modifications and supersedes the following:

- APB 11, *Accounting for Income Taxes*
- APB 24, *Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other Than Subsidiaries and Corporate Joint Ventures)*
- SFAS 37, *Balance Sheet Classification of Deferred Taxes*
- Numerous related FASB Interpretations (FAS Is) and Technical Bulletins (TBs)

Exceptions to Comprehensive Allocation

The only exceptions to comprehensive tax allocation are those discussed in APB 23, *Accounting for Income Taxes—Special Areas,* which SFAS 96 did not amend. These exceptions include the following:

- Undistributed earnings of subsidiaries
- Bad debt reserves of savings and loan associations
- Policyholders' surplus of stock life insurance companies

The exceptions in APB 23 were retained because of perceived complexities of measurement in the case of undistributed earnings and uniformity for the others.

Pronouncements Not Amended

SFAS 96 does not amend accounting for leveraged leases as required by SFAS 13, *Accounting for Leases,* and FAS I 21, *Accounting for Leases in a Business Combination.*

SFAS 96 continues to preclude the recognition of deferred taxes for deposits in statutory reserve funds by U.S. steamship enterprises.

SCOPE OF SFAS 96

Areas Covered

SFAS 96 establishes financial accounting and reporting standards for income taxes that are currently payable and for the tax consequences of (1) revenues, expenses, gains, and losses that are included in taxable income of an earlier or later year than the year they are recognized in financial income, (2) other transactions that create differences between the tax bases of assets and liabilities and their amounts for financial reporting, and (3) operating loss or tax credit carrybacks and carryforwards.

Applicability

The requirements of SFAS 96 apply to—

- Domestic federal income taxes (U.S. federal income taxes for U.S. enterprises) and to foreign, state, and local (including franchise) taxes based on income.
- An enterprise's foreign operations that are consolidated, combined, or accounted for by the equity method.
- Foreign enterprises for purposes of preparing financial statements in accordance with U.S. generally accepted accounting principles (GAAP).

Areas Not Changed

SFAS 96, in general, does not change the accounting for the investment tax credit, intercompany tax allocation, interim reporting, the proscription of discounting, and APB 23 exceptions to tax allocation.

Investment Tax Credit. The deferral and flow-through methods continue as acceptable alternatives in accounting for the investment tax credit. However, note that the Tax Reform Act of 1986 repealed the investment tax credit and limits the use of credits of prior periods that are carried forward.

Separate Statements of Subsidiary. SFAS 96 does not prescribe any single method for recognizing and measuring income taxes in the separately issued financial statements of an entity that is part of a group filing consolidated returns. However, it does add certain disclosure requirements, which will be discussed later.

Interim Reporting. Most of the provisions of APB 28, *Interim Reporting*, continue in effect except that the discrete approach is now required in implementing the effects of tax law changes. The entire effect of a change in tax rates must be recognized in the interim period of enactment.

Discounting. The proscription of discounting under APB 10, *Omnibus Opinion—1966*, continues in force. The extension of that proscription to business combinations, via the new approach to tax allocation, means that it will no longer be acceptable to discount the tax effects of fair value (book)/tax differences arising in connection with business combinations accounted for by the purchase method.

BASIC PRINCIPLES OF SFAS 96

SFAS 96 adopts the asset and liability approach to income tax allocation in place of the deferred approach of APB 11. Both approaches represent applications of comprehensive tax allocation, with the aforementioned exceptions. But there are important differences in application that would yield different results in all but the simplest of cases.

Asset and Liability Approach

Focuses on Individual Future Years. Under SFAS 96, the amount of the liability or asset for deferred taxes arising from temporary differences, including timing differences, is computed as if a tax return were prepared for the net amount of temporary differences, resulting in taxable or deductible amounts in each future year.

Includes Effects of Temporary Differences. A temporary difference is the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years, when the reported amount is either recovered or settled. Thus, such originating differences as depreciation, which give rise to deferred tax liabilities, represent taxable amounts in future years' tax returns in which they are scheduled to reverse.

Anticipates No Future Profits or Losses. It is assumed that the assets' carrying amounts will be recovered on a break-even basis. The asset and liability approach does not anticipate the tax consequences of earning income or incurring losses in future years. An originating difference, such as warranty expense, gives rise to a *future deductible amount* when it reverses and the cost is incurred. Again, no future earnings or losses are anticipated.

Classifies Deferred Taxes. A current and/or deferred tax liability or asset is recognized for the current and deferred tax consequences of all events that have been recognized in the financial statements.

Highlights Changes in Deferred Taxes. The income statement provision for deferred taxes is based on the year-to-year change in the balance-sheet amounts for deferred taxes. When the change in deferred taxes is either added to or subtracted from the provision for current taxes, the result is the income tax expense for the year.

Classifies Tax Effects Based on Turnaround Period. Consistent with the asset and liability approach, SFAS 96 calls for current-noncurrent classification based on the timing of the expected reversal rather than the classification of the related asset or liability giving rise to the timing difference.

Currently Recognizes Effect of Change in Tax Rates or Status. Additionally, the effect of a change in tax rates, tax laws, or the tax status of an entity on existing deferred tax liabilities and assets is recognized when the law is enacted or the entity's status changes. SFAS 96 also modifies the rules of accounting for net operating loss carryforwards.

Temporary Differences

Temporary differences include those items previously classified as timing differences, but with an emphasis now on the accrual of the appropriate balance sheet deferred tax amounts.

- Revenues or gains taxable after they are recognized in financial income (A receivable from an installment sale will result in taxable amounts when collected.)
- Expenses or losses deductible before they are recognized in financial income (In the case of depreciation differences, amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis, resulting in taxable income.)
- A reduction in the tax basis of depreciable assets due to tax credits (that is, taking the full ITC and reducing ACRS deduction)

- ITC accounted for by the deferral method
- Expenses or losses deductible after they are recognized in financial income (A product warranty liability will result in tax deductible amounts when the liability is settled.)
- Revenues or gains taxable before they are recognized in financial income (Subscriptions received in advance necessitate the recognition of a liability; future sacrifices to provide goods or services to settle the liability result in tax deductible amounts in a future year.)
- Temporary differences also include differences between the accounting and tax bases of assets acquired in a business combination accounted for as a purchase. Previously, such differences were accounted for on a net-of-tax basis and treated as permanent differences.
- Temporary differences not identified with a particular asset or liability for financial reporting include:

  —*Long-term contracts* that use percentage-of-completion reporting for book and completed contract basis for tax.

  —*Organization costs* that are written off for book purposes but amortized for tax purposes.

  In these cases, there is an asset or liability for tax purposes but none for financial reporting. These temporary differences will result in taxable or deductible amounts in future years.

Subsequent Recovery or Settlement

The amount actually recovered for a particular asset or paid to settle a particular liability in a subsequent year may be different from the amount recognized for financial reporting in the current year. The change in tax consequences resulting from the gain or loss would be recognized when the gain or loss is recognized.

"Permanent Differences"

Some events do not have tax consequences. For example, interest on municipal obligations is not taxable. Such items are classified as permanent differences in APB 11. SFAS 96 does not discuss permanent differences. The effects of permanent differences are not accounted for.

Recognition

SFAS 96 requires that a liability or asset be recognized for the deferred tax consequences of all temporary differences except those differences related to indefinite reversals (APB 23). (SFAS 96 eliminates the "with" and "without" approach as well as the use of gross change or net change methods.)

Assumes Only Temporary Differences. The measurement of a deferred tax liability or asset assumes that the only taxable or deductible amounts in future years are those that result from temporary differences at the end of the current year.

Future Recoveries or Settlements. Future recovery of assets and settlement of liabilities at their reported amounts are assumed events and result in taxable or deductible amounts in the future.

Anticipates No Future Profits or Losses. Recognition and measurement of taxable effects ignore the tax consequences of earnings or losses in future years. These are future events and are not anticipated regardless of probability for purposes of accounting for income taxes.

Net Change in Deferred Taxes Included with Current Tax. Deferred tax expense or benefit should be recognized for the net change during the year in an enterprise's liability or asset for deferred tax consequences. That amount together with income taxes currently payable or refundable is the total amount of income tax expense or benefit for the year.

Computing Deferred Income Taxes

The following procedures are applied in computing and reporting current and deferred income taxes. They are illustrated in the cases to follow.

1. *Current Tax.* Determine the income tax currently payable or refundable based on the current year's tax return.
2. *Schedule.* Schedule all temporary difference originations and reversals into future years and separate ordinary income differences from capital gains and losses.

3. *Net Taxable or Deductible.* Determine for each future year the net taxable or deductible amount.
4. *Net Operating Loss (NOL).* Deduct the NOL carryforward from each year's net taxable amounts that are within the limits of the carryforward period.
5. *Carryback or Carryforward Net Deductible Amounts.* Deduct the net deductible amounts for each year, after step 4, as an NOL carryback or carryforward.
6. *Tax-Planning Strategies.* Develop tax-planning strategies to permit the full utilization of carryforwards of net deductible amounts, thereby reducing a deferred tax liability or increasing a deferred tax asset.
7. *Deferred Tax Asset.* Recognize a deferred tax asset for carrybacks that reduce taxes paid in prior years or payable in the current year including deferred tax liabilities.
8. *Deferred Tax Liability.* Compute the taxes payable for each future year using currently enacted tax laws and rates.

   —Separate ordinary income from capital items.

   —Deduct tax credit carryforwards.

9. *Deferred Tax Expense.* Subtract the opening balances of deferred taxes from the closing balances to determine deferred income tax expense or benefit for the period. Combine the deferred income tax expense with the tax expense currently payable to arrive at the income tax expense for the period.
10. *Intraperiod Tax Allocation.* Allocate current and deferred income tax expense to the following:

    —Income from continuing operations

    —Discontinued operations

    —Extraordinary gains or losses

    —Cumulative effect of accounting changes

    —Retained earnings (Prior period adjustments)

    —Gains or losses carried directly to equity accounts

11. *Current-Noncurrent.* Classify net current and net noncurrent deferred tax assets or liabilities.
12. *Footnote Disclosure.* Comply with footnote disclosure requirements.

Scheduling

Conditions Requiring Scheduling

The scheduling of temporary differences (that is, assigning the differences to the years in which they become taxable or deductible) generally is required if any of the following conditions are present:

- There are both temporary taxable differences and deductible differences that may necessitate the carryback or carryforward of net deductible amounts, especially where tax-planning strategies are not available.
- Enacted tax rates significantly differ in future years.
- The effects of graduated tax rates are significant.
- Significant amounts of net operating loss or tax credit carryforwards exist.
- The alternative tax system may significantly impact the deferred tax determination.
- Deferred taxes must be classified as current or noncurrent in a classified balance sheet.
- Temporary differences exist for which tax-planning strategies are not available.
- The existence of net deductible amounts and net operating loss or tax credit carryforwards necessitates scheduling to determine whether such items can be recognized by carryback or carryforward.

Pattern of Taxable or Deductible Amounts

The particular years in which temporary differences will result in taxable or deductible amounts are determined by referring to the timing either of the recovery of the related asset or of the settlement of the related liability. Estimates may be required.

Contractual Arrangements. Scheduling is fairly evident where the recovery of the related asset or the settlement of the related liability is tied to a contractual arrangement involving collections and payments.

Inventory. LIFO inventory differences will result in taxable or deductible amounts when the reported amount of inventory is recovered—ordinarily one year. Future recovery is assumed; however, future purchases or inventory production are not assumed.

Note: The reported amount of LIFO inventory would be recoverable next year if inventory is estimated to "turn over" at least once a year. On that basis, a temporary difference for LIFO inventory would be considered taxable or deductible next year.

Depreciation. Scheduling may also be based on the systematic pattern of depreciation or amortization of long-lived assets. Differences related to depreciable assets may accumulate over several years and then eliminate over several years. Future temporary differences for existing depreciable assets (in use) are considered in determining the future years in which existing temporary differences result in net taxable or deductible amounts.

Future originating differences should not be scheduled if their subsequent reversal results in an increase in deferred tax liability greater than it otherwise would be based on consideration of only the net amount of temporary differences that exist at the date of the financial statements. The net taxable difference at the balance sheet date would be scheduled out on a FIFO pattern. The FASB's Special Report, *A Guide to Implementation of Statement 96 on Accounting for Income Taxes*, 1989 (p. 20), specifies—

> A first-in, first-out (FIFO) pattern should be used for all depreciable and amortizable assets in a particular tax jurisdiction if consideration of future originating differences results in creating net deductible amounts for which a tax benefit cannot be recognized and thereby either increases a deferred tax liability or reduces a deferred tax asset.

That result could occur because of limitations on the carryback or carryforward of net deductible amounts to other years, or it could occur if the deductible amounts are capital losses that can only reduce capital gains and if there are no capital gain temporary differences that can be offset.

Scheduling Estimates. Certain temporary differences, such as those that arise from allowances for obsolete inventory, loan losses, or unrealized losses on marketable equity securities long-term require estimates for scheduling. On the other hand, unrealized losses on investments in marketable equity securities short-term are assumed to result in deductible amounts on the first day of the next period because SFAS 96 prohibits anticipating future gains that may either offset existing losses or reduce their amount.

Indefinite Reversals. If asset recoveries or liability settlements are not likely to occur in the foreseeable future, such differences should be scheduled in an indefinite period. Nevertheless, tax liabilities would be recognized for such taxable amounts. Tax and book basis differences related to land would qualify as indefinite temporary differences if there are no plans to dispose of the land in the foreseeable future. However, such differences do not fall under the explicit exemption of APB 23 differences.

Present Values. Scheduling the pattern of taxable or deductible amounts when assets and liabilities are measured at present values poses special problems.

If the book basis exceeds its tax basis, each future cash receipt or cash payment may be allocated first to interest, with the remainder being considered a recovery or settlement of a temporary difference. An alternative approach is to base the scheduling pattern on the present value of each future cash receipt or cash payment.

Lessor. In situations in which a lessor accounts for a lease as a direct financing lease for financial reporting but treats the lease as an operating lease for tax purposes, two temporary differences are involved. One relates to the investment in the lease, which has a zero tax basis. The other difference relates to the leased asset for tax purposes, which has a zero book basis. For the investment in the lease for book purposes, the pattern of taxable amounts should follow that previously discussed for situations in which book basis exceeds tax basis. In the case of the temporary differences related to the leased asset for tax purposes, the scheduling would follow the depreciation pattern. Accounting for pension costs may also give rise to temporary differences that require the recognition of present values in dealing with the asset or liability.

Inventory Cost Capitalization. The Tax Reform Act of 1986 adopted uniform capitalization rules for inventory that would require capitalizing costs for tax purposes that are expensed for financial reporting. This requirement would give rise to a temporary difference that would result in a deductible amount when the inventory is sold. The other difference results from the catch-up adjustment, which will be included in taxable income over four years.

Intercompany Profits. Intercompany profit on a transfer of inventory or other assets between companies that are not included in a consolidated tax return results in temporary differences. Determination of whether to recognize a tax benefit and the amount of the benefit should be based on the tax circumstances of the acquiring company and not that of the selling company. The temporary difference will result in a deductible amount on the acquiring company's tax return in the future years when the cost of the inventory, as reported in the consolidated financial statements, is recovered.

Reduction of Scheduling. To reduce the amount of scheduling and detailed calculations otherwise called for, identify the type of a company's temporary differences and determine for each whether the tax law precludes or effectively precludes tax-planning strategies, which could alter the years in which temporary differences fall. (Tax-planning strategies required under SFAS 96 are discussed later.) For such difference scheduling is required. For others, determine whether there is a strategy that meets the criteria of SFAS 96, and if so, such difference may be offset for deferred tax calculations.

Deferred tax computations must be by ascending year and follow the ordering rules permitted or required by existing relevant tax law (related to carrybacks and carryforwards).

Shortcutting Scheduling. It may be possible in many cases to shortcut the scheduling process with no loss in fairness or compliance with SFAS 96. The shortcut approach is as follows:

1. Schedule all future tax deductible amounts first.
2. Schedule future taxable amounts to the extent necessary to determine whether the scheduled deductible amounts may be recognized.
3. Schedule the remaining taxable amounts in a single indefinite column.
4. Apply carrybacks and carryforwards of NOLs and then net deductible amounts, if any.
5. Determine the net taxable amounts for each year scheduled and for the indefinite column.
6. Apply appropriate tax rates.

Offset of Taxable and Deductible Amounts. If the tax law provides that capital losses or other items are deductible only to the extent of capital gains or other items, temporary differences that result in future deductions in the form of capital losses or other items cannot be offset against temporary differences that will result in future ordinary income.

Exhibit 3-1 is a tabular summary of selected accounts including a description of the nature of book and tax bases differences and identification of each difference as either a taxable or deductible amount. The table describes the approach to scheduling future taxable or deductible amounts for these differences.

Measurement of Deferred Tax Liability or Asset

A deferred tax liability or asset at each balance sheet date is computed by applying the provisions of the tax law to measure the tax consequences of temporary differences that will result in net taxable or deductible amounts in each future year, based on—

- Elections and options expected to be made, or that could be made, for tax purposes in future years.
- Enacted changes in tax laws or rates scheduled for a particular future year or years applied to differences arising or reversing in that year or years.

Tax laws and rates of the current year are used if no changes have been enacted for future years. Tax laws and rates of applicable prior years are used for net tax deductible amounts that will be realized based on carryback provisions.

A deferred tax liability is measured using tax rates applicable to capital gains and ordinary income, as appropriate. For example—

- Facts and circumstances (such as method of anticipated realization) would dictate whether a deferred tax on the equity in an investee's earnings should be measured as a capital gain or as a dividend.
- A consistent policy of selling depreciable assets might indicate that capital gain rates are more appropriate to measure deferred tax for differences between tax and book basis.

Exhibit 3-1 ***Temporary Differences—Identifying and Scheduling Future Taxable and Deductible Amounts***

		Book Basis Exceeds Tax Basis		*Tax Basis Exceeds Book Basis*		
Account	*Book and Tax Bases Differences*	*Asset (Taxable)*	*Liability (Deductible)*	*Asset (Deductible)*	*Liability (Taxable)*	*Scheduling of Future Taxable or Deductible Amounts*
Accrued expenses and estimated losses (discontinued operations, warranties, litigation)	Accrual basis for books, cash basis for tax purposes		√			Schedule as deductible amount in year(s) that amounts will be deducted for tax purposes. For warranties consider terms as well as historical experience.
Allowance for doubtful accounts	Allowance method for books, specific charge-off method for tax purposes (TRA 1986)		√			Schedule based on estimates of future specific charge-offs or historical experience based on aging schedule.
	IRC Section 481 for change in tax accounting				√	The existing allowance at the beginning of 1987 is "deferred income" for tax purposes to be taken into taxable income over

(continued)

Exhibit 3-1 ***(cont.)***

Account	*Book and Tax Bases Differences*	*Book Basis Exceeds Tax Basis* — *Asset (Taxable)*	*Book Basis Exceeds Tax Basis* — *Liability (Deductible)*	*Tax Basis Exceeds Book Basis* — *Asset (Deductible)*	*Tax Basis Exceeds Book Basis* — *Liability (Taxable)*	*Scheduling of Future Taxable or Deductible Amounts*
						four years. The account has a zero accounting basis resulting in taxable amounts.
Deferred intercompany profit in inventory	Tax basis of inventory will exceed consolidated financial statement basis by the amount deferred.			√		Schedule as a deductible amount in year(s) the profit will be recognized for financial reporting.
Intangible assets (except goodwill)	Faster write-off for tax than for books	√				Schedule over years of reversal based on planned systematic amortization.
	Allocated values in business combination, tax basis exceeds book basis (assume amortiz-			√		Schedule over years of reversal based on planned systematic amortization.

	able for tax purposes).				
Inventory	Allowance for obsolescence for books only		√		Schedule in year(s) the inventory will be disposed of and loss realized.
	Additional costs capitalized for tax only (uniform rules)		√		Schedule based on turnover of physical inventory (one year or operating cycle).
	Excess of current value over LIFO in business combination	√			Schedule based on turnover of physical inventory (one year or operating cycle).
	IRC Section 481 adjustments for change in tax accounting			√	Adjustments for capitalization as of January 1, 1987 are taken into taxable income over four years. There are, however, accelerating provisions in the tax law. The deferred income has a zero basis for book purposes.

(continued)

Exhibit 3-1 ***(cont.)***

		Book Basis Exceeds Tax Basis		*Tax Basis Exceeds Book Basis*		
Account	*Book and Tax Bases Differences*	*Asset (Taxable)*	*Liability (Deductible)*	*Asset (Deductible)*	*Liability (Taxable)*	*Scheduling of Future Taxable or Deductible Amounts*
Investments in marketable securities (short-term)	Lower of cost or market for books, cost for tax			√		Schedule for the year following the balance sheet date. If item is a capital loss, not deductible against ordinary income, then do not include with other amounts subject to ordinary income effects.
Investments in stock of other companies—20%–50% owned	Equity method for books, cost method for tax purposes (Assume investee's profits exceed dividends.)	√				Schedule the difference in the year the investor plans to sell the investment, unless realization is expected to occur in the form of dividends. Deferred tax must be provided because it does not fall under

					the APB 23 exception.
Land	Valuation assigned in business combination exceeds tax basis.	√			Assigned to year of expected disposal. If no such plans, assign to an indefinite period.
Leased fixed assets (plant, equipment)	Capital lease for books, operating lease for tax purposes	√			Schedule on basis of amortization of the asset.
	Leased asset (zero tax basis)	√			Schedule on basis of planned systematic depreciation.
	Lease liability (zero tax basis)		√		Schedule based on amortization of principal or based on the present value of future cash flows.
Lease receivable	Direct financing or sales-type lease for books, operating lease for tax purposes				
	Leased asset (zero book basis)			√	Schedule on basis of planned systematic depreciation.

(continued)

Exhibit 3-1 ***(cont.)***

		Book Basis Exceeds Tax Basis		*Tax Basis Exceeds Book Basis*		
Account	*Book and Tax Bases Differences*	*Asset (Taxable)*	*Liability (Deductible)*	*Asset (Deductible)*	*Liability (Taxable)*	*Scheduling of Future Taxable or Deductible Amounts*
	Less receivable (zero tax basis)	√				Schedule on basis of amortization of principal or present value of future cash flows.
Notes receivable	Accrual basis for books, installment method for tax purposes	√				Schedule deferred profit on installment sales on a recovery basis.
Pension costs	Pension asset (excess funding [expensing] for tax over book expense)	√				Schedule based on future years' pension expense for book purposes.
	Pension liability (book expense exceeds tax funding [expensing])		√			Schedule based on estimated future deductible contributions measured on a present value basis.

Plant and equipment	Faster write-off for tax than book	√		Schedule on basis of pattern of depreciation differences between book and tax including originating as well as reversing differences.
	Capitalize items for book, write-off for tax	√		Schedule on basis of book depreciation.
Prepaid expenses	Defer for book, write-off for tax	√		Schedule as expenses are to be recognized.
Unearned income	Accrual basis for book, cash basis for tax purposes		√	Schedule based on periods in which income will be earned.

COMPREHENSIVE CASE APPLICATIONS IN COMPUTATION OF DEFERRED TAXES

Company A has the following temporary differences at December 31, 19X1.

Fleet of trucks acquired January 1, 19X1, expected useful life six years, zero salvage value. Cost $4,500,000. Depreciation—for books, straight-line, six years; for tax 200 percent, five-year life. For the year 19X1, depreciation for books is $750,000, for tax $1,800,000. The book basis of the asset exceeds the tax basis at December 31, 19X1, in the amount of $1,050,000, giving rise to a future taxable amount. Based on future depreciation differences the amount is scheduled to reverse as follows:

	Depreciation		
Year	*Books*	*Tax*	*Future Taxable (Deductible) Amount*
19X2	$ 750,000	$1,080,000	$ (330,000)
19X3	750,000	648,000	102,000
19X4	750,000	486,000	264,000
19X5	750,000	486,000	264,000
19X6	750,000		750,000
	$3,750,000	$2,700,000	$ 1,050,000

An allowance for bad debts is used for financial accounting but the specific charge-off method is used for tax in accordance with requirements of the Tax Reform Act of 1986. The allowance for bad debts at December 31, 19X1, is $200,000. This gives rise to a temporary deductible amount. The tax basis is zero. It is estimated that specific charge-off of existing receivables will be $250,000 in 19X2 and $50,000 in 19X3.

Estimated losses at December 31, 19X1, on a discontinued operation are reflected for financial reporting in the amount of $500,000. Such losses are not deductible for tax purposes until realized. The tax basis of the allowance is zero. Therefore, this difference results in a deductible amount scheduled in the period when it is anticipated that the related assets will be disposed of. It is assumed that the assets will be sold in 19X3.

Inventory is written down by $100,000 for obsolescence. The write-down is not recognized for tax purposes. Therefore, the tax basis of the inventory is higher than the book basis, giving rise to a future deductible amount when the inventory is sold. It is anticipated that the entire inventory will be sold in 19X2.

Investments in marketable securities (short-term) are written down to the lower of cost or market. The amount of the write-down is $150,000. The tax basis of the investments is higher than the book basis. This difference will give rise to a future deductible amount when the securities are sold. It is assumed, for scheduling purposes, that the temporary difference will turn around in 19X2. For simplicity, it is further assumed that the amount is deductible from ordinary income.

Rent is received in advance for two years and is shown as unearned income for financial reporting in the amount of $200,000. The tax basis of the unearned income is zero because the amount is all taxable in the year 19X1, when the amount was received. The difference gives rise to a future deductible amount.

Machinery was acquired under a long-term noncancellable lease, which, for tax purposes, is treated as an operating lease. The annual rental for five years, starting January 1, 19X1, exclusive of executory costs, is $100,000. Implicit interest rate, which is lower than the incremental borrowing rate, is 10 percent. There is no guaranteed residual value. For tax purposes the leased asset and lease liability have zero tax bases. Therefore, the capitalized lease asset gives rise to a future taxable amount based on future book depreciation. The lease obligation will give rise to future deductible amounts based on future reductions in principal. (Present value of annuity of one dollar, five periods at 10 percent, annuity date, 4.170.)

The asset is recorded in the amount of $417,000 for book purposes. The liability is amortized as follows:

Date	*Payment*	*Interest*	*Balance*
1/1/X1			417,000
1/1/X1	100,000		317,000
12/31/X1		31,700	348,700
1/1/X2	100,000		248,700
12/31/X2		24,870	273,570
1/1/X3	100,000		173,570
12/31/X3		17,357	190,927
1/1/X4	100,000		90,927
12/31/X4		9,073	100,000
1/1/X5	100,000		0

The asset will be depreciated over five years on a straight-line basis.

Investment in stock of B Corporation represents a 23 percent interest. The investment carried at equity for financial reporting exceeds the tax basis by $300,000. Realization is expected to occur in the form of cash dividends of $200,000 for 19X2 and $100,000 for 19X3, ignoring the dividend received deduction.

The excess book basis over the tax basis gives rise to taxable amounts in 1988 and 1989.

Assume that Company A has no net operating loss carryforwards. Pretax accounting income is $600,000. Assume a tax rate for all years of 40 percent.

Schedule of Temporary Differences

Exhibit 3-2 shows the schedule of temporary differences and determination net taxable or deductible amounts based on the foregoing fact pattern. The journal entries to record taxes are shown below.

Journal Entries 19X1

Current tax expense	166,040	
Taxes payable		166,040
Deferred tax asset*	166,040	
Deferred tax expense**	73,960	
Deferred tax liability		240,000

*The deferred tax asset is a current asset based on the carryback of net deductible amounts from 19X2.

**The deferred tax expense is based on the change in the net deferred tax liability.

NOL Carryforward

The following case is based on the facts in the previous case and assumes that Company A had a net operating loss carryforward in 19X0 in the amount of $500,000. In that event, the scheduling would appear as shown in Exhibit 3-3.

Journal Entries 19X1

Deferred income tax expense	40,000	
Deferred tax payable		40,000

Notes:
- The NOL for tax purposes is $84,900.
- The carryforward for accounting purposes is zero.
- In accordance with SFAS 96, tax NOLs are scheduled before net deductible amounts are scheduled.

Again, based on the previous fact pattern, assume that the NOL carryforward in 19X0 is $700,000. The scheduling would appear as shown in Exhibit 3-4.

In this case the NOL for tax purposes is $284,900, whereas the NOL for accounting purposes is $100,000.

Exhibit 3-2

Company A Schedule of Temporary Differences
December 31, 19X1

		Years—Taxable (Deductible)				
	12/31/X1	*19X2*	*19X3*	*19X4*	*19X5*	*19X6*
1. Depreciation on equipment	$(1,050,000)	$(330,000)	$102,000	$264,000	$264,000	$750,000
2. Allowance for bad debts	200,000	(150,000)	(50,000)			
3. Allowance for losses—discontinued operations	500,000		(500,000)			
4. Inventory write-down obsolescence	100,000	(100,000)				
5. Investment in marketable securities—write-down to lower of cost or market	150,000	(150,000)				
6. Unearned rent income	200,000	(100,000)	(100,000)			
7. Leased asset, future depreciation	(333,600)	83,400	83,400	83,400	83,400	
Lease liability, future amortization	348,700	(75,130)	(82,643)	(90,927)	(100,000)	
Net deductible amount	15,100	8,270	757	(7,527)	(16,600)	
8. Investment in stock of B Corporation (23 percent owned)	(300,000)	200,000	100,000			
Net temporary differences	$ (184,900)	(621,730)	(447,243)	(256,473)	247,400	750,000

(continued)

Exhibit 3-2 *(cont.)*

Company A Schedule of Temporary Differences
December 31, 19X1

		Years—Taxable (Deductible)				
	12/31/X1	*19X2*	*19X3*	*19X4*	*19X5*	*19X6*
Pretax accounting income December 31, 19X1	600,000					
Net deductible amounts	(184,900)					
	415,1003*					
Taxable income	415,100**	415,100				
Carryforward		206,630		(206,630)		
Carryforward			447,243	(49,843)	(247,400)	(150,000)
		$ 0	$ 0	$ 0	$ 0	$600,000
Tax Rate is 40 percent						40%
Deferred tax liability						$240,000

*Taxes payable $415,100 × 40% = $166,040
**Deferred tax asset $415,100 × 40% = $166,040

Exhibit 3-3

Company A
Schedule of Temporary Differences with NOL and Deductible Balance
December 31, 19X1

	Current Year 19X1	Years–Taxable (Deductible) 19X2	19X3	19X4	19X5	19X6
Net temporary differences	$(184,900)	$(621,730)	$(447,243)	$256,473	$247,400	$750,000
Pretax accounting income	600,000					
Taxable income	415,100					
NOL carryforward	(415,100)			(84,900)		
Balance	$ 0					
Carryforward		621,730		(171,573)	(247,400)	(202,757)
Carryforward			447,243			(447,243)
		$ 0	$ 0	$ 0	$ 0	$100,000
Deferred tax liability						$ 40,000

Exhibit 3-4

Company A
Schedule of Temporary Differences with NOL and Deductible Balance
December 31, 19X1

	Current Year 19X1	*Years–Taxable (Deductible) 19X2*	*19X3*	*19X4*	*19X5*	*19X6*
Net temporary differences	$(184,900)	$(621,730)	$(447,243)	$256,473	$247,400	$750,000
Pretax accounting income	600,000					
Taxable income	415,100					
NOL carryforward	(415,100)			(256,473)	(28,427)	
Balance	$ 0					
Carryforward		621,730			(218,973)	(402,757)
Carryforward			347,243			(347,243)
		$ 0	$(100,000)	$ 0	$ 0	$ 0

TAX-PLANNING STRATEGIES

Under SFAS 96, the annual computation of a deferred tax liability or asset may be affected by tax-planning strategies that determine the years in which temporary differences will result in taxable or deductible amounts. Tax planning is required by SFAS 96; it is not elective.

Deductible in a Different Year. Amounts may become deductible in a different year and provide a tax benefit by offsetting taxable amounts as a carryback or carryforward, or by recognizing a deferred tax asset by loss carryback.

Taxable in a Different Year. Amounts may become taxable in a different year before a loss or tax credit carryforward expires, or in a particular year that maximizes the benefit of tax credits.

Criteria for Tax Planning

Tax-planning strategies that would change the future years in which temporary differences result in taxable or deductible amounts may be taken into account if they meet the following tests:

Recognition. The deferred tax consequences must be recognized at the balance sheet date.

Permitted by Law and Feasible. The strategy must be prudent, feasible, and permitted by the tax law, and management must have the discretion, control, ability, and intent to implement the strategy if necessary, to reduce taxes. Management does not need to carry out the strategy in the future if income earned in a following year permits realization of the entire tax benefit of a loss or tax credit carryforward from the current year. The criterion for utilization of a tax-planning strategy is not that management expects to use it but rather the intent to use it, if necessary, to reduce taxes.

No Significant Costs to the Enterprise. The strategy must not involve significant cost to the enterprise. The tax benefit derived from the strategy is not to be viewed as a cost reduction. The limitation includes costs that give rise to assets (for example, purchases of inventory).

Not Applied to Future Events

Tax-planning strategies do not apply to future events that are not inherently assumed in the financial statements, including those that result in generating profits or incurring losses in future years. Future events that are inherently assumed in the financial statements are those that result in the recovery or settlement of an enterprise's assets or liabilities.

Tax-Planning Actions

The actions considered here primarily involve accelerating or delaying the recovery of an asset or the settlement of a liability to minimize taxes.

Accelerate Taxable Amounts. Examples of tax-planning strategies that permit the recognition of a tax benefit for operating loss and tax credit carryforwards might be to accelerate taxable amounts to years before the carryforward periods expire.

- A "sale" of equipment for tax purposes and a leaseback under a capital lease accounted for as a financing arrangement would accelerate taxable amounts for a difference between the tax basis and the reported amount of the equipment. (Sale and leaseback at a loss would not be acceptable.)
- A transfer (a "sale" for tax purposes) of installment sale receivables, with recourse, accounted for as a financing arrangement for financial reporting, would accelerate taxable amounts for the gains in the installment sales.

Accelerate Deductible Amounts. A tax-planning strategy that would accelerate deductible amounts to an earlier future year would include making a larger-than-usual annual payment to reduce a long-term pension obligation recognized as a liability in the financial statements.

Elections. Tax-planning strategies include elections such as the following:

- Election to file consolidated tax returns
- Election to claim either a deduction or a tax credit for foreign taxes paid

- Election to forego a tax loss carryback
- Election to use the subsidiary's (80 percent or more owned) tax basis of its net assets rather than parent's tax basis for the stock of the subsidiary to determine taxable gain or loss on sale or liquidation
- Election to forego a carryback to preclude reopening prior tax years otherwise closed

Changes Are Not Strategies. A change in tax status is not a tax strategy but is recognized as a discrete event. Income shifting or termination of a pension plan are also not acceptable tax-planning strategies.

The following simple case, which involves the assumed early settlement of a litigation obligation in tax planning, reduces the overall tax liability and the amount classified as a current liability.

Tax-Planning Strategies Case

FG Corporation

FG Corporation's only temporary differences at December 31, 19X6, consist of the following:

- \$60,000 excess of tax depreciation over financial statement depreciation. Reversing 19X7 through 19X9 at \$30,000, \$20,000, \$10,000.
- \$20,000 reserve for litigation *expected* to be deductible in 19X9.

The tax rates are 46 percent in 19X6, 40 percent in 19X7, and 34 percent for all subsequent years.

As a tax-planning strategy, management adopts an assumed "settlement" of its litigation in 19X7. (Management has discretion and control over timing of the payment.)

Case Objective

This case will show how to calculate deferred tax liabilities current and noncurrent with tax planning and without tax planning.

An analysis of taxable and deductible amounts and the computation of the liabilities for deferred taxes, both with and without tax-planning strategy, appear in Exhibit 3-5. Under tax planning, the company moved the deductible amount of \$20,000 from year

19X9 to 19X7. As a consequence, it was also able to reduce its overall deferred tax accrual by $600.

$$\$10,000 \times (40 \text{ percent} - 34 \text{ percent}) = \$600$$

Additionally, it reduced the current balance by $8,000.

Exhibit 3-5 *FG Corporation*

	Balance 12/31/X6	*Taxable 19X7*	*(Deductible) 19X8*	*Reversals 19X9*
Depreciation	$60,000	$30,000	$20,000	$10,000
Litigation reserve	(20,000)	(20,000)		
	$40,000	$10,000	$20,000	$10,000
Using Tax Planning				
Deferred tax liability				
Current			($10,000 × 40 percent)	$ 4,000
Noncurrent			($30,000 × 34 percent)	$10,200
No Tax Planning				
Deferred tax liability				
Current			($30,000 × 40 percent)	$12,000
Noncurrent			(net of asset)	$ 2,800

OPERATING LOSS AND TAX CREDIT CARRYBACKS AND CARRYFORWARDS

Carryback. An asset is recognized for prior years' taxes that are refundable by carryback of an operating loss or unused tax credits of the current year.

Carryforward. An operating loss or tax credit carryforward is recognized as a reduction of a deferred tax liability for temporary differences that will result in taxable amounts during the operating loss or tax credit carryforward period. If not so recognized, the benefit cannot be recognized regardless of the probability of profits in future years.

The following case illustrates the treatment of a net operating loss carryback and carryforward under SFAS 96.

Net Operating Loss (NOL) Case

IJ Company

Assume that IJ Company has an operating loss of $16,000 in Year 5. Temporary differences in Years 1 through 7 relate to depreciation and are all deductible amounts. The temporary differences will result in taxable amounts before the end of the carryforward period from Year 5.

	Year 1	*Years 2 to 4* (3 years)	*Year 5*	*Year 6*	*Year 7*
Pretax financial income	$4,000	$10,000	$(16,000)	$4,000	$14,000
Depreciation differences	(1,600)	(4,400)	(1,200)	(1,600)	(1,200)
Cumulative depreciation differences	(1,600)	(6,000)	(7,200)	(8,800)	(10,000)

Tax rate for Years 1 through 7 is 40 percent.

Case Objective

This case will show how to compute the taxable income and tax payable, temporary differences and deferred tax liability balances, and tax expense for several years where there is an interaction between an NOL and deferred tax liabilities.

In Year 1, a deferred tax liability of $640 is recognized. Years 2 through 4, the deferred tax liability increases to $2,400, an increase of $1,760. The temporary taxable differences at the end of Year 4 total $6,000. In Year 5, an NOL of $17,200 is incurred, of which $5,600 is carried back to reduce taxable income in Years 2 through 4 and $2,240 of taxes paid is refunded. The $11,600 NOL carryforward exceeds the $7,200 of temporary differences that will result in taxable amounts in future years. Therefore, the $2,400 deferred tax liability at the beginning of Year 5 is eliminated. Tax expense in Year 5 is $(4,640).

In Year 6, $2,400 of the NOL carryforward is used to offset taxable income earned in Year 6. The balance of the NOL carryforward of $9,200 exceeds the $8,800 of cumulative temporary difference, and there is no deferred tax liability.

In Year 7, the NOL carryforward of $9,200 is used up to partially offset income of $12,800. Therefore, $1,440 of taxes are payable on net taxable income of $3,600. No loss carryforward offsets the $10,000 of cumulative temporary differences that will result in taxable amounts in future years, and the $4,000 of deferred tax liability must be reinstated.

Exhibit 3-6 *IJ Company*
Taxable Income and Tax Payable

	Year 1	*Years 2 to 4*	*Year 5*	*Year 6*	*Year 7*
Pretax financial income	$4,000	$10,000	$(16,000)	$ 4,000	$14,000
Depreciation	(1,600)	(4,400)	(1,200)	(1,600)	(1,200)
difference	2,400	5,600	(17,200)	2,400	12,800
Loss carryback			5,600		
Loss carryforward				(11,600)	(9,200)
Taxable income	$2,400	$ 5,600	$(11,600)	$ (9,200)	$ 3,600
Tax payable (refundable)	$ 960	$ 2,240	$ (2,240)	$ 0	$ 1,440

IJ Company
Temporary Differences and Deferred Tax Liability Balance

	Year 1	*Years 2 to 4*	*Year 5*	*Year 6*	*Year 7*
Unreversed differences					
Opening balance	—	$ 1,600	$ 6,000	$ 7,200	$ 8,800
Additions	$1,600	4,400	1,200	1,600	1,200
	1,600	6,000	7,200	8,800	10,000
Tax loss carryforward			(11,600)	(9,200)	
Net taxable amount	$1,600	$ 6,000	$ 0	$ 0	$10,000
Deferred tax liability					
End of year balance	640	2,400	0	0	4,000
Opening balance	0	640	2,400	0	0
Tax expense (benefit)	$ 640	$ 1,760	$ (2,400)	$ 0	$ 4,000

Exhibit 3-6 ***(cont.)***

IJ Company
Tax Expense

	Year 1	*Years 2 to 4*	*Year 5*	*Year 6*	*Year 7*
Tax Expense					
Payable	$ 960	$ 2,240	$ (2,240)	0	$ 1,440
Deferred	640	1,760	(2,400)	0	4,000
Total	$1,600	$ 4,000	$ (4,640)	0	$ 5,440

Notes: *In Year 5:* $5,600 is carried back to reduce taxable income in Years 2 through 4, and $2,240 of tax would be refundable.

In Year 6: A portion of the loss carryforward is used to offset taxable income earned in Year 6.

In Year 7: The loss carryforward is used up.

Carryforward for Tax Purposes and for Financial Reporting

If there is an operating loss carryforward for tax purposes, an operating loss carryforward for financial reporting is determined by taking the amount for tax purposes—

1. Reduced by the amount that offsets temporary differences that will result in net taxable amounts during the carryforward period.
2. Increased by the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

Illustrations of the Interaction of Carryforwards for Tax and Financial Reporting

Situation 1

An operating loss carryforward for financial reporting when a tax loss carryforward is reduced by temporary differences that will result in taxable amounts during the carryforward period. Year 1 is the first year of operations. The enterprise's only temporary differences are depreciation differences.

	Years 1 to 3	Year 4
Pretax financial income (loss)	$800	$(1,200)
Depreciation differences	(160)	(40)
Taxable income (loss)	640	(1,240)
Loss carryback for tax purposes	(640)	640
Loss carryforward for tax purposes	$ 0	$ (600)
Loss applied to offset depreciation differences ($160 + $40)		200
Loss carryforward for financial reporting		$ (400)

Situation 2

An operating loss carryforward for financial reporting when a tax carryforward is increased by temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements. Year 1 is the first year of operations. The enterprise's only temporary differences are warranty expense differences that will result in deductible amounts in future years.

	Years 1 to 3	Year 4
Pretax financial income (loss)	$800	$(1,600)
Warranty expense differences	160	40
Taxable income (loss)	960	(1,560)
Loss carryback for tax purposes	(960)	960
Loss carryforward for tax purposes	$ 0	$ (600)
Warranty expense differences ($160 + $40)		(200)
Loss carryforward for financial reporting		$ (800)

Carryforward for Accounting Purposes. If there is no operating loss carryforward for tax purposes, an operating loss carryforward for financial reporting is the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

Subsequent Recognition of NOL Carryforward. The tax benefit of an operating loss carryforward that is recognized subsequent to the year of the loss is reported in the same manner as the source of income that gave rise to the use of the operating loss carryforward. Under APB 11, the amount was treated as an extraordinary item.

INTRAPERIOD ALLOCATION OF INCOME TAXES

Income taxes should be allocated to the following:

- Continuing operations
- Discontinued operations
- Extraordinary items
- The cumulative effect of accounting changes
- Prior-period adjustments
- Gains or losses included in comprehensive income but excluded from net income
- Capital transactions

Allocation to Continuing Operations

The amount of income tax expense or benefit allocated to income or loss from continuing operations (in addition to adjustments for changes in tax status and tax laws or rates) is computed on pretax income or loss exclusive of any other items that occurred during the year (for example, extraordinary items).

Allocations to Other Items

The amount of tax allocated to items other than continuing operations is the incremental effect on income taxes that results from that category of items.

Allocation to Two or More Other Items

When allocated to two or more categories of items other than continuing operations, the sum of the incremental tax effects of each category of items sometimes may not equal the incremental tax effect of all categories of items because of a statutory limitation on the utilization of tax credits, for example. In those circumstances the allocation procedure is as follows:

- Determine the incremental tax benefit of the total net loss for all net loss categories and apportion that incremental benefit ratably to each net loss category.
- Apportion ratably to each net gain category the difference between the incremental tax effect of all categories other than

continuing operations, and the incremental tax benefit of the total net loss for all net loss categories.

The procedure for allocating income taxes to each item within each category of items is similar to the aforementioned procedure described above.

Allocation of Deferred Income Tax Expense

Deferred tax expense or benefit should be allocated to income from continuing operations and other items in the same manner as current tax expense or benefit.

When allocating a deferred tax benefit to continuing operations, a company should consider the total amount of income taxes paid during the carryback period and not just the portion of those taxes that was allocated to continuing operations.

Allocation to Effect of Accounting Change

Note that no portion of tax expense for the current year is usually allocated to an accounting change that is computed in accordance with paragraph 20 of APB 20 (cumulative effect), because a cumulative effect is ordinarily determined as of the beginning of the year of the change. If this is not the case (rarely), an allocation of a portion of the current year's tax to the cumulative effect is appropriate.

Consider a simple situation of intraperiod tax allocation. Assume that pretax financial income and taxable income are the same.

Loss from continuing operations	$(1,000)
Loss carryback would give rise to a refund of $200 of taxes paid on $500 of taxable income during the carryback years.	
Extraordinary gain	1,800

Tax rate for all items is 40 percent.

Income taxes currently payable are $320 on $800 of taxable income.

Allocation

Tax consequences of loss from continuing operations	$ (200)
Extraordinary gain—incremental tax consequences	520

This hypothetical computation of tax consequences of loss from continuing operations results in incremental tax of $520 on extraordinary gain.

The following illustrates intraperiod tax allocation where there is more than one category other than continuing operations.

Case on Intraperiod Tax Allocation–More Than One Category Other Than Continuing Operations

KL Corporation

Pretax financial income includes:	
Income from continuing operations	$1,200
Discontinued operations	(200)
Extraordinary items	1,000
Cumulative effect of an accounting change	(400)
Total pretax financial income	$1,600

- KL Corporation has $600 of tax credits available subject to a limitation of 90 percent of taxes payable.
- There are no temporary differences.
- Tax rate is 34 percent.

Case Objective

This case shows how to allocate income taxes to all components of income and cumulative effect of accounting change.

Exhibit 3-7 shows initially that continuing operations on a stand-alone basis would have a tax of $40. The total tax, however, is $54. Therefore, the incremental effect of the other items in the income statement totals $14.

The next step is to determine the tax benefit of the loss categories, in total and for each loss category. The aggregate tax benefit is $94, which is apportioned 8/34 to discontinued operations, and 26/34 to the cumulative effect.

Finally, the tax allocated to the extraordinary gain is $108, based on a $14 overall tax to items other than continuing operations, plus a tax benefit of $94 on the sum of the loss categories.

Exhibit 3-7 ***KL Corporation***
Income Tax Expense Attributable to Continuing Operations

	Continuing Operations	*Total*
Pretax financial income	$1,200	$1,600
Tax at 34 percent	408	544
Tax credits (90-percent limitation)	368	490
Tax expense	$ 40	$ 54

The incremental effect of income tax from all items other than continuing operations is $14.

The allocation of the incremental effect is as follows:

	Sum of Loss Categories	*Loss Category Discontinued Operations*	*Loss Category Cumulative Effective of Change*
Taxable income	$1,600	$1,600	$1,600
Loss category	(600)	(200)	(400)
Taxable income without loss categories	$2,200	$1,800	$2,000
Tax at 34 percent	748	612	680
Tax credit (90-percent limitation)	600	500	600
Tax without loss categories	148	62	80
Total expense	54	54	54
Incremental effect	$ 94	$ 8	$ 26

The $94 tax benefit is allocated on a pro-rata basis to the sum of the net loss categories:

	Each Loss Category Amount	*Each Loss Category Percent*	*Apportioned Amounts*
Discontinued operations	8	24	22
Cumulative effect of accounting change	26	76	72
	$34	100	$94

The tax allocated to the extraordinary item is $108.

This is the difference between the $14 tax expense for all other items and the $94 tax benefit for the loss categories.

Total tax expense is allocated as follows:

	Pretax Income	*Tax Expense*
Income from continuing operations	$1,200	$ 40
Discontinued operations	(200)	(22)
Extraordinary items	1,000	108
Cumulative effect of accounting change	(400)	(72)
	$1,600	$ 54

Allocation of Income Tax to Stockholders' Equity

Stockholders' equity is charged or credited for the income tax effects of—

- Adjustments to opening retained earnings for the effect of a change in accounting principles or correction of an error.
- Gains and losses recognized in comprehensive income but not in net income.
- An increase or decrease in contributed capital (for example, tax deductible expenditures reported as a reduction in the proceeds from the issuance of capital stock).
- Expenses for employee stock options recognized differently for financial reporting and tax purposes.

Note: An income tax benefit for the tax deductibility of dividends paid to stockholders is recognized as a reduction of income tax expense and is not credited directly to stockholders' equity.

DISCLOSURE REQUIREMENTS

Balance Sheet

Classification—Current Asset

A deferred tax liability or asset should be classified in two categories—current and noncurrent—in a classified balance sheet. The current amount is the net deferred tax consequences of—

- Temporary differences that will result in net taxable or deductible amounts during the next year.

- Temporary differences related to an asset or liability that is classified for financial reporting as current because of an operating cycle that is longer than one year.
- Temporary differences for which there is no related, identifiable asset or liability for financial reporting whenever other related assets and liabilities are classified as current because of an operating cycle that is longer than one year.

No Offset

Deferred tax items attributable to different tax jurisdictions should not be offset.

Disclosure

The nature or type of temporary differences that give rise to a significant portion of a deferred tax liability or asset should be disclosed.

A publicly held enterprise that is not subject to income tax because its income is taxed directly to its owners should disclose that fact and the net difference between the tax basis and the reported amounts of the enterprise's assets and liabilities.

Detailed Disclosure—APB 23 Differences

Detailed disclosures are called for whenever a deferred tax liability is not recognized for any of the areas addressed in APB 23 or for deposits in statutory reserve funds by U.S. steamship enterprises. See SFAS 96, paragraph 25.

In the following three situations the tax rate is 40 percent and the temporary differences are scheduled. The requirement is to determine the current and noncurrent amounts for deferred tax. (Assume that the enterprise has no taxable income in Year 1, the start of operations.)

	Current Year	*Future Years*		
Situation 1:	*Temporary Differences*	*Year 2*	*Year 3*	*Year 4*
Liability for warranties	$(1,000)	$(1,000)		
Installment receivables	1,600		1,600	
	$ 600	$(1,000)	$ 1,600	

	Current Year	*Future Years*		
Situation 2:	*Temporary Differences*	*Year 2*	*Year 3*	*Year 4*
Liability for warranties	$(1,000)		$(1,000)	
Installment receivables	1,600	$ 1,600		
	$ 600	$ 1,600	$(1,000)	

Situation 3:				
Liability for warranties	$(1,000)	$(1,000)		
Installment receivables	1,600		$ 1,600	
Liquor inventory*	1,400			$1,400
	$ 2,000	$(1,000)	$ 1,600	$1,400

*Operating cycle—5 years

In situation 1, the deductible amount in Year 2 is carried forward to Year 3. Therefore, the deferred tax liability of $240 (40 percent × $600) is noncurrent.

Situation 2 presents a noncurrent deferred tax asset of $400 (40 percent × $1,000), and a current deferred tax liability of $640 (40 percent × $1,600). The deductible amount of $1,000 can be carried back to Year 2 to offset the taxable amount of $1,600 and therefore can be recognized as an asset.

Finally, in situation 3, there would be a current liability for the inventory because the recovery falls within the operating cycle ($1,400 × 40 percent = $560). The warranty difference of $1,000 would be carried forward to Year 3 and offset against the taxable amount of $1,600, reducing the taxable balance to $600. The noncurrent deferred tax liability would be $240 ($600 × 40 percent).

Income Statement

Disclosure of Allocated Amounts

Disclosure is required of the amount of income tax expense allocated to the following:

- Continuing operations
- Discontinued operations
- Extraordinary items

- Cumulative effect of accounting changes
- Prior-period adjustments
- Gains and losses included in comprehensive income but excluded from net income
- Capital transactions

Note: SFAS 96 precludes including interest and penalties in tax expense.

Disclosure of Components of Expense

The significant components of income tax attributed to continuing operations for each year presented should be disclosed, including the following:

- Current tax expense or benefit
- Deferred tax expense or benefit
- Investment tax credit
- Government grants
- Operating loss carryforward benefits
- Adjustments of deferred tax for changes in tax laws, or rates, or change in status of entity

Reconciliation of Reported Tax and Statutory Amounts

Reconciliation (using percentages or dollar amounts) of the reported amount of tax expense attributable to continuing operations to the amount that would have been reported by applying the domestic federal statutory rates to pretax income from continuing operations should be disclosed. Statutory rates should be the regular rates if there is an alternative tax system.

- The estimated amount and nature of each reconciling item should be disclosed.
- Nonpublic enterprises need not list the reconciling items, but must disclose the nature of significant items.

Carryforwards

Disclose the amounts and expiration dates of operating loss and tax credit carryforwards for financial reporting purposes (amounts not recognized as reductions of a deferred tax liability) and for tax purposes.

If any amount of benefit will be used to reduce goodwill, it should be disclosed separately.

Separate Statements of Subsidiary

If a company is included in a consolidated tax return, then it should disclose in its separate statements—

- The amount of current and deferred tax expense.
- The amount of tax-related balances due to or from affiliates.
- The method of intercompany tax allocation and the nature and effects of any change in methods.

Disclosure—Implementation Issues

Current-Noncurrent Classification

Inventory is generally the only balance sheet item that can be classified as current with an operating cycle that is longer than one year. All other items are classified in relation to a one-year operating cycle.

Disclosure of Significant Components of Income Tax Expense

SFAS 96 requires the disclosure of the significant components of income tax expense attributable to continuing operations. The sum of the amounts disclosed should equal the amount of tax expense that is reported in the income statement. Separate disclosure of the tax benefit of operating loss carryforwards and tax credits that have been recognized as a reduction of current tax expense and deferred tax expense is required. But the amounts disclosed for current tax expense and for deferred tax expense can be either before or after reduction for those tax benefits.

If a tax benefit for an operating loss carryforward is recognized by reducing a deferred tax liability in Year 1 and the carryforward is realized on the tax return in Year 2, there is no effect on income tax expense in Year 2 because the reduction in current tax expense for the benefit realized in Year 2 is offset by the increase in the deferred tax expense.

Acquired Operating Loss Carryforward Benefit

If the tax benefit of an acquired operating loss carryforward is recognized after the date of a purchase business combination and is applied to reduce goodwill and intangible assets, income tax expense is increased. Disclosure is required of any increase in the current or deferred tax expense that results from applying the tax benefit of an acquired operating loss carryforward to reduce goodwill and intangible assets.

Expiration Dates for Operating Loss Carryforwards for Financial Reporting

Operating loss carryforwards for tax purposes that do not offset temporary differences that will result in taxable amounts have expiration dates as determined by tax law. The expiration dates for temporary differences are determined by adding the length of the loss carryforward period to the particular future years in which those temporary differences will result in net deductible amounts.

Nonrecognition of Tax Benefits in Income

Disclosure is required of any significant amounts of tax expense that result from not recognizing certain tax benefits in the statement of earnings, including the tax benefit of an acquired NOL or tax credit carryforward that reduces goodwill and intangible assets and certain other items, such as those that may arise in quasi reorganizations and employee stock options.

EFFECTIVE DATES AND TRANSITION

SFAS 96, as amended by SFAS 100, is effective for fiscal years beginning on or after December 15, 1989; however, the Board has decided to further defer the effective date to fiscal years beginning after December 15, 1990. Earlier application is encouraged, and restatement of previously issued financial statements is permitted.

Initial Application

Initial application should be as of the beginning of an enterprise's year.

Restatement Elected—Earliest Year Not Presented

If restatement is elected and the earliest year restated is prior to the years presented in the financial statements, then the cumulative adjustment should be to the opening balance of the retained earnings of the earliest year presented.

Restatement Elected—Earliest Year Presented or No Restatement

In all other cases, the cumulative effect should be included in determining net income of the earliest year restated or in the year first applied if no prior year is restated. Pro-forma effects of retroactive application are not required if statements of earnings presented for prior years are not restated.

Effects of Adoption Disclosed

The financial statements for the year SFAS 96 is first adopted should disclose the effects of adopting the statement of income from continuing operations, income before extraordinary items, net income, and related per-share amounts. Also, there should be similar disclosure for the effect of any restatements.

Remeasurement of Purchase Combinations

If restatement is elected, the company must remeasure in accordance with SFAS 96 *all* purchase business combinations occurring in the first year restated and in all subsequent years.

Remeasurement Not Permitted

For purchase combinations consummated before the beginning of the earliest year restated or if restatement is not elected, the enterprise may not remeasure any such prior purchase business combinations. Remaining balances will be left unchanged. Except for leveraged leases, any differences between those remaining balances and their tax bases are temporary differences, and a deferred tax liability or asset should be recognized as of the beginning of the year SFAS 96 is first adopted. This will in most cases increase the cumulative effect.

Special provisions apply to regulated enterprises, which are not discussed here.

Effects of Remeasurement

The following illustrates the financial statement effects of the remeasuring versus the nonremeasurement of purchase combinations.

Assume that MN Corporation acquires Company S's assets in a 19X1 purchase business combination. The assets had an initial fair value of $200 and a tax basis of zero. The tax rate at the date of acquisition was 40 percent, and the net-of-tax-value was recorded at $120. The assets have not been amortized to date.

If MN restates its 19X1 financial statements, it must remeasure purchase business combinations consummated during the period of restatement as follows:

The assets initially recorded net of tax	$120
Deferred tax gross up	80
Revised book value	200
Tax basis	0
Temporary difference	200
Tax rate	40%
Deferred tax liability	$ 80

Note: No cumulative effect adjustment because the net asset under the liability method and the result under the old rule are identical.

If the company does not restate 19X1, it does not remeasure prior business combination, and the analysis is as follows:

The recorded book value is	$120
Tax basis	0
Temporary difference	120
Tax rate	40%
Deferred tax liability	$ 48

Note: A cumulative effect of $48 would be recorded in this case.

Under the restatement and remeasurement approach, income in future periods would be reduced by $120, resulting from the amortization of the $200 asset and the reversal of the $80 deferred tax liability.

Under no restatement and remeasurement, the amortization of the asset of $120 would be offset by the reversal of the $48 tax liability, reducing net income by $72.

The transition approach can affect future reported earnings.

Transition—Implementation Issues

If an enterprise elects to apply SFAS 96 by restating prior years, it may choose the earliest year that is restated. The enterprise need not restate all prior years' financial statements presented.

SFAS 96 further notes the following situations where a transition adjustment, or a part thereof, is excluded from net income:

- Paragraph 33—Initial recognition of the tax benefits related to a quasi reorganization
- Paragraph 23—Tax benefit of an acquired operating loss or tax credit carryforward
- Paragraph 75—Tax benefits of deductions related to employee stock options credited to capital
- Paragraph 70—Tax benefits attributable to the increase in tax bases of assets acquired in a taxable business combination accounted for as a pooling

ALTERNATIVE MINIMUM TAX

Comprehensive Tax System

Alternative Tax System. The alternative minimum tax (AMT) is viewed as a comprehensive tax system that is an alternative to the "regular tax" systems with the higher outcome of the calculation determining the actual tax liability. The alternative system should be used to measure an enterprise's deferred tax asset or liability in a manner consistent with the tax law.

Applied to Interperiod Tax Allocation. After giving consideration to any interaction between the two systems, such as the alternative minimum tax credit, the deferred tax asset or liability is recognized based on the results of the two calculations for each future year.

Impacts on Temporary Differences. Existing temporary differences may be recognized or measured differently under each of the two tax systems, or a temporary difference may exist for only one system because of different recognition or measurement provisions.

AMT Tax Credit. The tax law allows the excess of the tentative minimum tax (TMT) over the regular tax, with some adjustment, as a tax credit to be carried forward indefinitely and used to reduce a regular tax liability but not an AMT liability. The minimum tax credit consists of that portion of the AMT attributable to deferral items, as opposed to such exclusion items as preferences.

The following illustrates the computation of the minimum tax credit.

Minimum Tax Credit

Regular taxable income		$ 820,000
Deferral items		1,562,000
Preference items		18,000
AMTI		2,400,000
TMT	Rate 20-percent AMTI	480,000
	Regular tax ($820,000 × 34 percent)	278,800
	AMT	$ 201,200
AMT	Credit	
	Regular taxable income	$ 820,000
	Preference items	18,000
		838,000
TMT	(Rate 20 percent × 838,000)	167,600
	Regular tax	278,800
AMT	Without deferral preferences	0
Minimum tax credit carryforward against future year's regular tax liability		$ 201,200

AMT Tax Credit Reduces Deferred Tax Liability. The AMT tax credit, which has an indefinite life, can be used to reduce only a certain portion of regular tax owed in future years and can be used with the limitations set forth in SFAS 96 as an offset to originating and existing deferred tax credits. However, any remaining AMT tax credit may not be recognized as a deferred tax asset.

Deferred Tax Liability Based on Higher Computation. The amount of a deferred tax liability to be recognized under SFAS 96 should be based on the higher of the deferred tax liability computed for the regular tax and for the AMT.

AMT—NOL. AMT NOL deduction may not exceed 90 percent of Alternative Minimum Taxable Income (AMTI) before the deduction. The AMT NOL is the same as the regular tax NOL reduced by preference items included in the loss and modified for any adjustments.

Determination of AMT Amount

It is beyond the scope of this chapter to discuss the details of the AMT. Certain basic principles need to be understood, however, to follow the case illustrating the interaction between the regular tax, AMT, and deferred income taxes. The computation is as follows:

Calculating AMT

Beginning with regular taxable income (add back NOL deduction), follow these steps:

- *Add:* AMT preference items, that is, amounts related to the preference component of percentage depletion, intangible drilling costs, charitable contributions of appreciated property, private-activity tax-exempt interest, and accelerated depreciation on certain property placed in service before January 1, 1987.
- *Add or deduct:* Adjustments for items treated differently for AMT represent effects of depreciation on post-1986 assets, and alternative accounting for circulation expenditures; mining exploration and development; long-term contracts; installment sales; passive activity losses; and certain other items.

Tentative AMT Income

- *Add:* Book income adjustment (50 percent of adjusted financial reporting income—tentative AMT income).*
- *Deduct:* AMT NOL deduction not to exceed 90 percent of AMTI before the deduction. (AMT NOL must be reduced for preference items.)
  - — AMT income × AMT rate (20 percent**) yields
  - — TMT (Less foreign tax credits, 90-percent limit, and investment tax credit carryover 25-percent limit). Overall: 90-percent limit.
- Deduct: Regular tax

The foregoing calculations yield the AMT.

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*Adjusted financial reporting income is based on income reported in the enterprise's financial statements with a priority ordering for the use of different financial statements, i.e., SEC filings, certified statements, and the like, and includes adjustments. Book income must take into account all items of income, expense, gain, and loss for the year including extraordinary items, cumulative adjustments resulting from accounting changes, and prior-period adjustment to retained earnings.

Adjust book income by such items as—

- *Income taxes*—Eliminate federal and foreign taxes, except foreign taxes prededucted for income tax purposes. Any item reflected in financial statement net-of-tax should be grossed up.
- *Disclosures*—Book income must be increased by amounts disclosed in footnotes, or other supplementary information, if disclosure results in a greater amount of book income. (This excludes disclosures if authorized by GAAP or reflecting "historic practice.")
- *Cumulative effect*—Exclude amounts attributable to years before 1987.
- *Related corporations*—Adjust to confirm financial statements to reflect applicable members.
  - — Eliminate book income and add dividends received from parties consolidated for book, but not tax, purposes.
  - — Eliminate excess of equity method income over dividends received (as measured for tax purposes) from parties not consolidated for book or tax purposes.
  - — Eliminate all income and the excess of equity method income over dividends received for parties excluded from the consolidated tax return.

**The rate is 20 percent on AMTI in excess of $40,000, if AMT is higher than regular tax. The $40,000 exemption is reduced by 25 percent of AMTI over $150,000 and entirely phased out when AMTI reached $310,000.

ACE Adjustment Replaces Book Income Adjustment. Beginning with taxable years after December 31, 1989, the financial reporting income adjustment will be replaced by an Adjusted Current Earnings computation (ACE), which is essentially Subchapter C Earnings and Profits with certain adjustments. Under the U.S. Tax Code, the ACE adjustment is 75 percent of the amount by which ACE exceeds AMTI, exclusive of the ACE adjustment and any AMT NOL deduction and can result in taxable or deductible amounts. There are limits, however, to the deduction for ACE.

The following case illustrates the interaction of the regular tax, AMT, and deferred income taxes.

Case on Determination of Deferred Tax Liability and Provision for Income Tax–Application of AMT

The enterprise is a U.S. enterprise whose tax liability is determined based on the Tax Reform Act of 1986. A 35 percent tax rate of regular taxable income is assumed for all years. Additional assumptions are as follows:

- The current year, Year 1, is the enterprise's first year of operations.
- The enterprise has tax-exempt income of $2,600 from municipal bonds (nonpreference) in the current year.
- U.S. tax law provides that the book income adjustment, a feature of the AMT system, will be replaced by an adjustment for ACE; that change is assumed to occur in Year 5.
- Depreciable assets that cost $2,000 were acquired in the middle of the current year and will be depreciated as follows:

			Depreciation	
	Financial Reporting	*Regular Tax Depreciation 40 Percent*	*AMT 30 Percent*	*ACE*
Year 1	$ 200	$ 400	$ 300	
Year 2	400	640	510	
Year 3	400	384	356	
Year 4	400	230	334	
Year 5	400	230	334	$250
Year 6	200	116	166	250
	$2,000	$2,000	$2,000	$500

Financial income and income taxes currently payable for the current year are as follows:

Regular tax calculation:		
Pretax financial income	$4,000	
Municipal bond income	(2,600)	
Depreciation difference	(200)	
Regular taxable income	$1,200	
AMT calculation:		
Regular taxable income		$1,200
Depreciation adjustment [Difference between regular tax and AMT depreciation ($400 − 300)]		100
Tentative AMTI		1,300
Book income adjustment [50 percent of ($4,000 − 1,300)]*		1,350
AMTI		$2,650
TMT (20 percent)		$ 530
Income taxes currently payable		$ 530
(The AMT is $530 − $420 = $110)		

*The book income adjustment is equal to one-half of the amount by which pretax financial income exceeds tentative AMTI. No book income adjustment is made in years in which tentative AMTI exceeds pretax financial income.

The enterprise's current tax liability will be $530 (regular tax $420 plus AMT $110). Within certain limitations, in this example, the tax law permits the excess of the TMT over the regular tax ($110) to be carried forward and used as a credit against the regular tax in future years. However, the AMT credit can only be carried forward and cannot be used to reduce a future year's regular tax below the TMT for that future year.

At the end of the current year (Year 1), a liability for the deferred tax consequences of depreciation differences is calculated as shown in Exhibit 3-8 (amounts are rounded to the nearest dollar).

Temporary differences between financial reporting depreciation and regular tax depreciation appear in Exhibit 3-8, line 1. The ($240) deductible amount is carried back to Year 1. Deferred tax on a regular tax basis appears on line 4. The ($84) item in Year 1 is the benefit of the loss carryback at the 35 percent rate.

The computation of deferred taxes on an AMT basis appears on lines 5 through 13. The tentative AMTI is the difference between the regular taxable temporary depreciation differences, line 5, and the AMT depreciation adjustment on line 6. In essence, line 7 represents the temporary depreciation differences arising from the excess of financial reporting depreciation over AMT depreciation.

The book income adjustment, line 8, applies only if book income is higher than tax income. The book income adjustment does not apply in Year 1 because of the loss carryback. In Year 2, the book income adjustment is $55 because the zero book income (SFAS 96 assumes a break-even in future years) is greater than the tentative AMTI loss of $(110). The ACE adjustment for Years 5 and 6 is 75 percent of the amount by which ACE exceeds AMTI, exclusive of ACE adjustment and any AMT NOL deductions. See Exhibit 3-8(a). The ACE adjustment appears on line 9.

AMT NOL deduction may not exceed 90 percent of the AMTI before the deduction. There is no limit here because AMTI in Year 1 is $2,650, whereas the NOL is $(55). The AMT NOL ($55) is the same as the regular tax NOL ($240) reduced by preference items included in the loss and modified for any adjustments. The loss carryback to Year 1 results in—

- An $84 reduction in regular tax (line 4).
- An $11 reduction in TMT (line 13).
- A $73 increase in AMT carryforward ($84 − $11) (line 18).
- The carryforward at the end of Year 1 is $183 (line 19) and consists of the $110 carryforward arising in Year 1 (TMT $530 − regular tax $420) and the $73 resulting from the loss carryback from Year 2.
- The AMT credit carryforward of $183 does not change in Year 2 but is carried forward to Year 3.

The higher of the regular tax or AMT appears in line 14. The AMT credit carryforward is used in Year 3 to reduce the regular tax of $6 to $3, which is both the AMT and the deferred tax liability (lines 15 and 16). As a result, the carryforward is reduced to $180 at the end of Year 3. The AMT carryforward continues to reduce the deferred tax liability but not below the AMT.

Based on the scheduling in Exhibit 3-8, the deferred tax liability in Year 1 is $321 (line 16) and consists of a current deferred tax asset of $11 and a noncurrent deferred tax liability of $42.

Exhibit 3-8

Calculation of Deferred Income Tax
Under Regular Tax and Alternative Minimum Tax

	Carryback to Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*
Regular Tax Calculation:						
1. Taxable (deductible) amounts	$ 0	$(240)	$ 16	$ 170	$ 170	$ 84
2. Loss carryback	$(240)	(240)	0	0	0	0
3. Regular taxable amounts	$(240)	$ 0	$ 16	$ 170	$ 170	$ 84
4. Regular tax (35 percent)	$ (84)	$ 0	$ 6	$ 60	$ 60	$ 30
AMT calculation:						
5. Regular taxable amounts before loss carryback and carryforward	$ 0	$(240)	$ 16	$ 170	$ 170	$ 84
6. AMT depreciation adjustment	$ 0	$ 130	$ 28	$(104)	$(104)	$(50)
7. Tentative AMTI	0	(110)	44	66	66	34
8. Book income adjustment*	0	55	0	0		
9. ACE adjustment**					63	(63)
10. AMTI before loss carryback	0	(55)	44	66	129	(29)
11. Loss carryback	(55)	55	(29)	0	0	29

12. AMTI	$ (55)	$ 0	$ 15	$ 66	$ 129	$ 0
13. TMT (20 percent)	$ (11)	$ 0	$ 3	$ 13	$ 26	$ 0
14. Higher of regular tax or TMT	$ (11)	$ 0	$ 6	$ 60	$ 60	$ 30
15. AMT credit carryforward applied	0	0	3	47	34	30
16. Deferred tax liability of $31	$ (11)	$ 0	$ 3	$ 13	$ 26	$ 0
AMT Credit Carryforward:						
17. Beginning of year	$ 110	$ 183	$183	$ 180	$ 133	$99
18. Add (deduct)	73	0	(3)	(47)	(34)	(30)
19. End of year	$ 183	$ 183	$180	$ 133	$ 99	$69

*Financial income in future years under SFAS 96 is zero; therefore, the book income adjustment is $55 because the zero book income is greater than the TAMTI of $(110).

**The ACE adjustment is equal to 75 percent of the difference between TAMTI and ACE. Unlike the book income adjustment, the ACE adjustment, subject to certain limitations, can result in deductible or taxable amounts. For purposes of this example, it is assumed that depreciation is the only reason for differences between pretax financial income, regular taxable income, TAMTI, and ACE.

Exhibit 3-8(a) ***Calculation of ACE Adjustment***

The ACE adjustments for Years 5 and 6 are calculated as follows:

	Year 5	*Year 6*
TAMTI	$ 66	$ 34
ACE depreciation adjustment*	84	(84)
ACE	150	(50)
TAMTI	66	34
ACE less TAMTI	$ 84	$(84)
75 percent of difference	$ 63	$(63)

*The depreciation adjustment is computed as the difference between AMT depreciation and ACE depreciation.

Note: Adjustments for ACE include such items as the following:

- Depreciation is based on the "slower" of financial reporting depreciation or ACE depreciation. ACE depreciation depends on when the property was acquired. For example, for property placed in service after December 31, 1989, the alternative depreciation system under ACRS is used (straight line over asset depreciation range class life).
- Intangible drilling costs and mine exploration costs are capitalized and amortized over the slower of the financial reporting method or a 60-month (intangible) or 120-month (mining) amortization period beginning at the start of the production.
- Exclusion items such as tax-exempt interest are included for ACE.
- Depletion for property placed in service after December 31, 1989, is cost depletion or financial reporting depletion, whichever produces the smaller present value of the deduction.
- Other adjustments relate to LIFO inventories, and dividends received exclusion.

APPENDIX A

Advanced Topics in Accounting for Income Taxes

CHANGES IN TAX RATES OR TAX STATUS OF ENTITY

Recognition of Change in Rates. The effect of a change in tax rates on existing deferred tax liabilities or assets is recognized when the law is enacted or the entity's status changes.

Change in Tax Status. Upon a change in tax status from non-taxable to taxable or the reverse, a deferred tax liability or asset must be recognized or eliminated.

Allocation of Effects of Change. The effects are allocated entirely to income from continuing operations.

Comparison to APB 11. Note that under APB 11, recognized changes in tax rates or tax laws that affected components of equity, such as translation adjustments, were allocated to that component.

Illustration of Treatment of Change in Tax Rates

To see the effect of this change in treatment on the relationship between a deferred tax liability and the equity account, consider the following example.

Case A on Treatment of Change in Tax Rates. An enterprise's only temporary difference at the end of Years 1 and 2 is the foreign currency translation adjustment of $1,000 which arose in Year 0.

The tax rate changes from 40 percent to 34 percent at the beginning of Year 2.

Exhibit A

Income Statement (selected accounts):	*Year 1*	*Year 2*
Pretax income from continuing operations	$2,000	$2,000
Income tax expense (benefit):		
Current	800	680
Deferred		(60)
	$1,200	$1,380
Effective tax rate	40%	31%*
Balance Sheet (selected accounts):		
Deferred income taxes payable	$ 400	$ 340
Equity:		
Cumulative translation adjustment	$1,000	$1,000
Deferred taxes thereon	400	400
Net balance	$ 600	$ 600

*The effective tax rate is lower than the statutory rate of 34 percent because of the effect of the change in tax rate on the temporary difference.

It is evident that after the tax rate change, the balance in the cumulative translation adjustment account does not reflect the current tax rate.

Practice Prior to SFAS 96

Under previous practice, deferred tax accounts are not adjusted for the effects of a change in tax rates until the temporary difference reverses. When adjusted, the effects are allocated to income or to components of equity such as translation adjustments, if relevant.

Case B on Change in Tax Rates. At December 31, 19X0, HI Corporation had charged $10,000 more depreciation for tax than book. This depreciation difference will reverse as follows: 19X1, $2,000; 19X2, $3,000; and 19X3, $5,000.

At December 31, 19X0, Company E had recorded a $4,600 deferred tax credit related to this depreciation difference. The company used the net change method. Tax rates are 19X0-X1, 46 percent; 19X2, 40 percent; and 19X3, 34 percent.

Case Objectives

Assuming HI Corporation adopted SFAS 96 in 19X1, this case shows how to compute the amortization of the deferred tax liability under the liability approach in SFAS 96 and under the deferred approach in APB 11.

Note: Under SFAS 96, the effect of an enacted change in tax rates impacts the deferred tax liability and expense in the year of change. Tax expense would be reduced by an additional $780 in the enactment year. Whereas, under APB 11, the reversals would continue based on original scheduling without giving immediate effect to the change in tax rates.

Exhibit B

HI Corporation
Amortization of Deferred Tax Credits

Year	*Percent*	*Liability Method*	*Deferred Method*
19X1	46%	$1,700	$ 920
19X2	40%	1,200	1,200
19X3	34%	1,700	2,480
Total		$4,600	$4,600

Note: The tax rate change effect is as follows:

Reversal	
19X2 $3,000 × (46% − 40%) =	$ 180
19X3 5,000 × (46% − 40%) =	600
Rate reduction benefit reduces liability in 19X1	$ 780
19X1 Reversal $2,000 × 46% =	$ 920
Total reduction of liability in 19X1	$1,700

Clearly scheduling is important here.

Under APB 11, the effect of the rate reduction would appear in 19X3.

Case C on Change in Tax Rates and Computation of Effect of Tax Rate Change. The following case illustrates the computation of the effect of a change in tax rates.

Assume that the deferred tax liability at December 31, 19X1, is $1,067, computed as follows:

	Total	*Prior*	*19X2*	*19X3*	*19X4*	*19X5*
(Originating) or reversing amount	$2,320		$(680)	$1,000	$1,000	$1,000
Carryback to 19X0		$(680)	680			
(Loss) or taxable amount	2,320	(680)	0	1,000	1,000	1,000
Tax rate		.46		.46	.46	.46
Deferred tax liability or (asset)	$1,067	$(313)	$ 0	$ 460	$ 460	$ 460

During 19X2, the tax rates change as follows: 19X3, 40 percent; 19X4 and 19X5, 34 percent. Continuing with the preceding example, the deferred tax for December 31, 1982, would be $1,080.

	Total	*19X3*	*19X4*	*19X5*
(Originating) or reversing amount	$3,000	$1,000	$1,000	$1,000
(Loss) or taxable amount	3,000	1,000	1,000	1,000
Tax rate		.40	.34	.34
Deferred tax liability	$1,080	$ 400	$ 340	$ 340

Assume that in 19X2 the company had reported $10,000 pretax income. The amount of income tax expense for the year would be $4,300.

Pretax income	$10,000	
Additional asset cost recovery	(680)	
Taxable income	9,320	
Tax rate	.46	
Taxes currently payable		$4,287
Deferred tax liability January 1	1,067	
Deferred tax liability December 31	1,080	
Deferred tax expense		13
Income tax expense		$4,300

The effect of the tax rate change alone is determined using with and without procedures to compute the change in the deferred tax liability or asset.

The amount of the deferred tax liability at the end of 19X2 if tax rates had not changed would be $1,380.

	Total	*19X3*	*19X4*	*19X5*
(Originating) or reversing amount	$3,000	$1,000	$1,000	$1,000
(Loss) or taxable amount	3,000	1,000	1,000	1,000
Tax rate		.46	.46	.46
Tax payable	$1,380	$ 460	$ 460	$ 460
With tax rate change:				
Increase in deferred tax liability (from above)				$ 13
With tax rate change:				
Deferred tax liability January 1			$1,067	
Deferred tax liability December 31			1,380	
Increase in deferred tax liability				313
Benefit of tax rate change				$300

The deferred tax expense would have been $300 higher if tax rates had not changed. Therefore, the benefit of the tax rate change is $300. This amount must be disclosed separately on the income statement or in notes to financial statements.

Tax Status

Change in Status Filed. An enterprise that files an election to change its tax status should recognize the effect of that voluntary change on the date that the change is approved by the taxing authority or on the date of filing the election if approval is not necessary. The effect of a change in tax status is a discrete event and should be recognized in the period it occurs.

Election of S Corporation. If an enterprise elects S Corporation status after December 31, 1986, it is subject to a corporate-level tax on any unrecognized "built-in gain" realized during the 10-year period after the conversion to S Corporation status. The gain is taxable on the subsequent disposition of any asset and is determined by applying the maximum corporate rate applicable to the particular type of income to the lesser of (a) the amount of the built-in gain realized for that year or (b) the amount that would be taxable income for that year if the enterprise were not an S Corporation.

Built-in gains may result in temporary differences which at the date of conversion consist of the excess, if any, of (a) the lower of either the appraised value or the reported amounts of the company's assets over (b) the tax bases of those assets.

Note: A temporary difference for inventory is considered to result in a taxable amount in the following year. However, there would be no taxable amount for depreciable assets if recovery of those assets will be by use in operations.

BUSINESS COMBINATIONS

Pooling—Purchase. For financial reporting, a business combination can be either of the following:

- A pooling of interest in which assets and liabilities are maintained at book values
- A purchase in which assets and liabilities of the acquired company are revalued to reflect at least a portion of the difference between book and market value, based on the percentage of ownership, and goodwill is recognized

Taxable—Nontaxable. For tax purposes, a combination can be viewed as—

- Taxable in which the acquired corporation revalues its assets and liabilities to reflect acquisition values.
- Nontaxable in which original tax bases are maintained.

Revaluation—Nonrevaluation. There are four possible combinations of financial reporting and tax treatment, as shown by the following chart.

	Pooling	*Purchase*
Taxable	Revalue for tax purposes only	Revalue for tax and for financial reporting
Nontaxable	No revaluation	Revalue for financial reporting only

Combination Types

Nontaxable Purchase. In practice, the most common type of business combination is a nontaxable purchase.

Nontaxable Pooling. The second most common type is a nontaxable pooling. This second type causes no temporary differences other than those that already exist unless net operating loss or similar carryforwards are possible.

Taxable Pooling. A taxable pooling is possible, but it doesn't occur frequently. A pooling-of-interests combination may be a taxable combination. The increase in the tax basis of the net assets acquired results in temporary differences requiring a deferred tax liability or asset. As of the combination date, recognizable tax benefits attributable to the increase in tax basis are allocated to contributed capital. Tax benefits attributable to the increase in tax basis that become recognizable after the combination date are reported as a reduction of income tax expense.

Taxable Purchase. Taxable purchase combinations were frequent before the Tax Reform Act of 1986. They are of interest here only if SFAS 96 is applied retroactively to years before 1986. Such combinations would produce temporary differences only if the revaluation for tax purposes differed from the revaluation for financial reporting purposes. Such a situation is rare.

Differences in Tax and Financial Reporting Bases

1. In purchase business combinations, one of the major issues for both tax and financial reporting purposes is the computation of goodwill.
2. Amortization of goodwill is not allowed for tax purposes, and financial statement amortization is often spread over as many as 40 years.
3. Therefore, corporations frequently are motivated to assign the minimum justifiable amount to goodwill. SFAS 96 amended prior pronouncements to specify goodwill computation procedures.
4. Under SFAS 96, assets and liabilities of an acquired company are valued without considering income tax consequences. A deferred tax liability or asset is determined for the resulting temporary differences of the acquired company at the date of acquisition.
5. Under SFAS 96, a temporary difference cannot be associated with goodwill, unallocated negative goodwill, or leveraged

leases that are present in the financial records of the acquired company.

6. If the purchase price exceeds the aggregate of the revalued assets and liabilities and deferred tax liability or asset, the result is goodwill.
7. If the aggregate amount exceeds the purchase price, noncurrent assets (except marketable securities) are first reduced to zero, and any excess is negative goodwill. This latter provision is the same as under previous pronouncements.

Purchase Business Combinations. Differences between the assigned values and the tax bases of assets and liabilities (except goodwill or unallocated negative goodwill and leveraged leases) of an enterprise acquired in a purchase business combination require the recognition of a deferred tax liability or asset.

1. The SFAS 96 changes current practice, which utilizes net-of-tax approach and a discounted valuation. Both of these applications would be proscribed under the new Statement.
2. The following situation illustrates the application of SFAS 96 to a nontaxable purchase combination.

Purchase Business Combination—Nontaxable, Differences Between Assigned Values and Tax Basis of Assets

Purchase price	$40,000
Tax basis of net assets acquired	10,000
Assigned value of net assets, other than goodwill	24,000

Future recovery of assets and settlements of liabilities will result in taxable and deductible amounts that can be offset against each other.
Tax rate is 40 percent.

The application of SFAS 96 requires that goodwill of $21,600 and a deferred tax liability of $5,600 be recognized as follows:

Net assets	$24,000
Goodwill	21,600
Deferred tax liability	$ 5,600
Cash	40,000

The deferred tax liability is:

$$(\$24{,}000 - \$10{,}000) \times 40 \text{ percent} = \$5{,}600$$

The difference between assigned net asset value and the tax basis is a temporary difference.

Note: (1) Under APB 16 and APB 11, the entry would be as follows:

Net assets	\$24,000 − \$5,600	\$18,400	
Goodwill		21,600	
Cash			\$40,000

Other things being equal, the future net income under the two approaches would be the same.

Note: (2) In computing the deferred income tax expense or benefit for a year in which a business combination has occurred, the addition to or deduction from a net deferred income tax liability or asset resulting from the combination is treated as an adjustment to the opening balance of a net deferred tax liability or asset.

Purchase Business Combination—Taxable, Values Assigned to Goodwill for Tax and Accounting Purposes Differ

Purchase price	\$40,000
Tax basis of net assets acquired, other than goodwill	40,000
Accounting basis of net assets acquired, other than goodwill	24,000
The acquiring enterprise has a deferred tax liability of \$60,000 that will result in net taxable amounts in future years, and the acquired \$16,000 of temporary differences will result in deductible amounts in the same future years.	
Tax rate is 40 percent.	

SFAS 96 allows the use of the future taxable amounts of the acquiring company in determining the amount of future deductible amounts of the acquired company that can be recognized at the date of acquisition. Therefore, the deferred tax liability debit is an offset to the deferred tax credit of the acquiring company.

The amount is based on 40 percent of the temporary difference (\$40,000 − \$24,000).

Net assets, other than goodwill	$24,000	
Deferred tax liability (acquiring enterprise)	6,400	
Goodwill	9,600	
Cash	$40,000	$90,000

If the tax basis and accounting basis of net assets are identical, there are no temporary differences.

Operating Loss and Tax Credit Carryforward—Purchase Method. Accounting for a business combination should reflect any provisions in tax law that permit or restrict the use of either company's operating loss carryforwards to reduce taxable income or taxes payable attributable to the other company subsequent to the combination.

If permitted by tax law or by tax election (consolidated tax return), an operating loss or tax credit carryforward for financial reporting purposes of either combining enterprise may be recognized as a reduction of a deferred tax liability of the other, as of the acquisition date. This results in either reducing goodwill or noncurrent assets (except long-term investments in marketable securities) of the acquired enterprise or creating or increasing negative goodwill.

The Tax Reform Act of 1986 changed rules regarding utilization of carryforwards of other companies. Therefore, recognition of an acquired company's NOL as an offset to an acquirer's deferred tax liability may be an exception rather than the rule.

To contrast the new rules, note that according to APB 11—

- Net-of-tax values were required to be assigned to acquired assets and liabilities.
- Subsequent recognition of purchased NOL carryforwards could result in retroactive restatement of purchase-price allocation.
- Carryforwards subsequently recognized were recorded by reducing goodwill to zero.
- Noncurrent assets were reduced and any remaining amounts were recorded as a negative goodwill.
- No consideration could be given to an acquirer's NOL or tax credit carryforwards at the acquisition date.

To illustrate the application of SFAS 96 to a purchase combination in which a loss carryover exists, consider the following facts:

Loss Carryforward—Nontaxable Purchase Business Combination

Purchase price	$40,000
Net assets—assigned value	24,000
Tax basis	10,000
Acquired enterprise—operating loss carryforward (may be used by acquiring company in the consolidated tax return)	32,000
Temporary differences of acquiring and acquired company will result in taxable amounts before the end of the loss carryforward period.	
Acquiring company has a deferred tax liability that stems from temporary differences that will result in net taxable amounts in future years.	
Tax rate is 40 percent.	

In this situation, the $32,000 operating loss carryforward offsets the net taxable amount of $14,000. This is the difference between tax basis and accounting basis of net assets, and it will result in future taxable amounts.

The remaining $18,000 operating loss carryforward will be offset against the acquiring company's deferred tax liability. This step results in reducing the acquiring company's deferred tax liability amount of $7,200 ($18,000 × 40 percent) and it reduces the amount that would otherwise be assigned to goodwill.

Journal Entry:

Net assets	$24,000	
Deferred tax liability	7,200	
Goodwill	8,800	
Cash		$40,000

Carryforward—Pooling-of-Interests. For restatement of periods prior to the combination, an operating loss carryforward of an acquired enterprise does not offset the acquiring company's taxable income because consolidated tax returns cannot be filed for those periods.

However, if consolidated tax returns are expected to be filed subsequent to the combination, one combining company's operating loss carryforward in a prior period reduces the other enterprise's deferred tax liability in the loss and subsequent periods to the extent that—

- The temporary differences will result in taxable amounts subsequent to the combination date.

- The loss carryforward can reduce those taxable amounts based on provisions of the tax law.
- The tax benefit is recognized as part of the adjustment to restate financial statements on a combined basis for prior periods.
- The same requirements apply to tax credit carryforwards and to temporary differences that will result in net deductible amounts in future years.

Subsequent Recognition of Carryforward Benefits. If not recognized at the acquisition date, the tax benefits of an acquired enterprise's operating loss or tax credit carryforward for financial reporting purposes that are recognized in financial statements after the acquisition date should first be used to reduce to zero any goodwill and other noncurrent intangible assets related to the acquisition and then be recognized as a reduction of income tax expense.

Additional amounts of carryforwards for financial reporting purposes arising after the acquisition date and before recognition of the tax benefits of amounts existing at the acquisition date are recognized as a reduction of income tax expense.

If both types of carryforwards exist, the attribution of the tax benefit is determined by the provisions of the tax law that identify the sequence in which the amounts are utilized for tax purposes. If not determinable by provisions in the tax law, the tax benefit recognized is prorated between a reduction of goodwill and other noncurrent intangibles and income tax expense.

The following case illustrates the recognition of tax benefits subsequent to a business combination:

Case D on Recognition of Tax Benefits Subsequent to a Business Combination. JK Corporation acquires S Company in a nontaxable purchase business combination occurring January 1, 19X1.

	Assigned Values	*Tax Basis*
Net assets acquired	\$10,000	\$12,000
Goodwill (no other intangibles)	3,000	
Purchase price	\$13,000	

- The excess of tax basis over the assigned value of identified net assets does not meet the criteria for recognition of a deferred tax asset.
- There are no other temporary differences.
- Disregard goodwill amortization.
- Pretax loss from operations for 19X1 is $6,000. Pretax income from operations for 19X2 is $5,000.
- In 19X1 the net assets acquired for $10,000 are sold at book value, giving rise to a $2,000 tax loss.
- Tax rate in 19X1 and 19X2 is 40 percent.

Case Objective

This case shows how to allocate tax benefit of loss carryforward.

The determination of taxable income and net income for 19X1 and 19X2 and the application of SFAS 96 to the determination of income tax expense appears in Exhibit D.

The realization in 19X2 of the tax benefit of the tax loss carryforward of $2,000 ($5,000 × 40 percent) is apportioned between the tax loss in the sale of assets and the operating loss.

The $8,000 loss carryforward at the end of 19X1 has two components.

- $2,000 (25 percent) is attributable to the excess of tax basis over the assigned value of the identified net assets acquired at the date of the business combination.
- $6,000 (75 percent) is attributable to the excess of tax basis over the assigned value of the identified net assets acquired at the date of the business combination.

Provisions in the tax law do not distinguish between those two components, and the component that is utilized for tax purposes is indeterminable.

Therefore, in 19X2 the $2,000 tax benefit (40 percent of $5,000) is prorated so that goodwill is reduced $500 (25 percent of $2,000) and tax expense is reduced $1,500 (75 percent of $2,00). Because $500 of the tax benefit reduces goodwill, $500 of tax expense is reported in 19X2.

Exhibit D ***Allocation of Tax Benefit of Tax Loss Carryforward After a Purchase Combination***

	JK Corporation	
	Financial Income	*Taxable Income*
Tax Determination		
19X1—Pretax operating loss	$(6,000)	$(6,000)
Loss on sale of assets		(2,000)
Tax loss carryforward (no taxes paid in prior years)		$(8,000)
19X2—Pretax income from operations	$ 5,000	$ 5,000
Tax loss carryforward		(8,000)
Taxable income		$ 0
Income Statement		
Pretax income (loss)	$(6,000)	$ 5,000
Income tax expense		500
Net income (loss)	$(6,000)	$ 4,500

Apportionment of Tax Benefit of Loss

Tax loss on asset sales	$2,000	= 25 percent × $2,000 = $500 allocated to goodwill reduction
Operating loss	$6,000	= 75 percent × $2,000 = $1,500 allocated to tax expense reduction
	$8,000	

Journal Entry:

Income tax expense	500	
Goodwill		500

Financial and taxable income for 19X3 is as follows:

	JK Corporation	
	Financial Income	*Taxable Income*
Income from operations	$3,000	$3,000
Loss carryforward		(3,000)
Taxable income		$ 0

The consolidated statement of earnings would be as follows:

Pretax income	$3,000
Income tax expense	300
Net income	$2,700

The $1,200 benefit of the operating loss carryforward (40 percent of $3,000) is prorated so that goodwill is reduced $300 (25 percent of $1,200). Because $300 of the tax benefit reduces goodwill, $300 of tax expense is reported in 19X3.

Business Combinations—Implementation Issues

Acquired NOL. The recognition of an acquired NOL or tax credit carryforward should be *first* applied to reduce good will to zero. Next, other noncurrent intangible assets related to the acquisition are reduced to zero. Then, any additional recognized benefit reduces income tax expense.

Subsequent Recognition of Acquiring Company's NOL. If a tax benefit for some or all of an acquiring company's operating loss carryforward for financial reporting cannot be recognized at the acquisition date as a reduction of the acquired company's deferred tax liability because the criteria for recognition are not met, the tax benefit should be reported as a reduction of income tax expense when recognized in the financial statements for subsequent years.

Other Intangibles. Deferred taxes should be provided for temporary differences related to intangible assets other than goodwill. Goodwill is a residual and is one of the four exceptions to comprehensive tax allocation.

Potential Reallocation for Tax Purposes. If a reallocation of the purchase price for tax purposes is probable, recognition and measurement of a deferred tax liability or asset at the date of the purchase business combination should be based on the expected final tax allocation, not the initial allocation. For reporting periods prior to finalization of the purchase price allocation, the enterprise should recognize a deferred tax liability for those excess tax deductions and determine deferred taxes based on the expected final purchase price allocation. At the date that the purchase price allocation is finalized, the enterprise should adjust its deferred tax liability or asset to reflect the revised tax basis of the purchase assets and liabilities and the amount of any settlement with the IRS for prior-year income taxes. The effect of that adjustment should be applied to increase or decrease the remaining balance of goodwill.

Tax Basis of Stock of an Acquired Enterprise. If the tax basis in the stock of an acquired company exceeds the tax basis of the net assets of the acquired company, the excess will result in deductible amounts if the stock is sold or the business is liquidated.

Prior to sale or liquidation, the potential tax benefit does not meet the recognition requirements of SFAS 96 whenever a deferred tax liability is not recognized for that acquired enterprise's APB 23 differences or deposits by U.S. steamship enterprises. The potential tax benefit is included in the computation of the unrecognized deferred tax liability that is disclosed for those items. Otherwise, the recognition requirements would be met to the extent that the deductible amount reduces a deferred tax liability for temporary differences that do not result in taxable amounts until the acquired enterprise is sold or liquidated.

For example, it would reduce the enterprise's deferred tax liability for the temporary difference related to a gain as a result of the acquired enterprise's sale of stock at a price that exceeds the per-share carrying amount.

CHAPTER 4
GASB Statements

CHAPTER 4
GASB Statements

GOVERNMENTAL ACCOUNTING STANDARDS BOARD

In 1984, the Financial Accounting Foundation (FAF) Board of Trustees established the jurisdictional division between the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). That arrangement provided that "the GASB will establish standards for activities and transactions of state and local governments, and the FASB will establish standards for activities and transactions of all other entities."

Hierarchy of Principles

The hierarchy of generally accepted accounting principles applicable to state and local government entities is as follows:

- Pronouncements of GASB (includes pronouncements of the National Council on Governmental Accounting (NCGA) acknowledged as applicable by GASB)
- Pronouncements of FASB
- Pronouncements of bodies composed of expert accountants that follow a due process procedure, including broad distribution of proposed accounting principles for public comment, for the intended purpose of establishing accounting principles or describing practices that are generally accepted
- Practices that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry or the knowledgeable application of a specific circumstances of pronouncements that are generally accepted
- Other accounting literature

Accounting Principles for Special Entities and Activities

The generally accepted accounting principles applicable to special entities and activities are those guided by standards of the FASB, except where the GASB has issued a pronouncement applicable to those special entities or activities. Thus a GASB Standard takes precedence over a FASB Standard for a transaction related to these special entities and activities.

Special Entities. Special entities include organizations such as colleges, utilities, hospitals, and pension plans. There can exist, however, privately run counterparts to these special governmentally owned entities. This has raised concerns over comparability of reporting between governmentally owned enterprises and privately run enterprises.

Activities. Activities also include airports, housing finance, toll roads, ports, transit authorities, solid waste treatment facilities, public entity risk pools, lotteries, and so forth. These activities are typically accounted for in proprietary funds.

Jurisdictional Dispute. In 1988, the Financial Accounting Foundation conducted a mandatory five-year review of the GASB, including the 1984 jurisdictional arrangement. One of the recommendations in January 1989 by the Committee to Review Structure of Government Accounting Standards was that the FASB should be the primary accounting standards setter for the separately issued statements of certain governmentally owned special entities. However, GASB could require some additional data to be presented within the report. This recommendation proved so controversial and unacceptable to many that the FAF recommended that the 1984 jurisdictional arrangement remain in force. A second recommendation emanating from the review concerns a modification in the Generally Accepted Accounting Principles (GAAP) hierarchy for governments. With respect to that, the precise language is being worked on by an AICPA Auditing Standards Board Task Force, and an exposure draft is expected to be issued by year-end 1990.

Overview of GASB Statements

Exhibit 4-1 lists the title and date of the thirteen GASB Statements released to date. In this chapter, we review those Statements released over the last two years, GASB Statements Nos. 9, 10, 11, 12, and 13.

Exhibit 4-1 ***Governmental Accounting Standards Board***

Final Pronouncements as of July 1990	
Title	*Date Issued*
Statement No. 1, *Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide*	7/84
Technical Bulletin, *Purpose and Scope of GASB Technical Bulletins and Procedures for Issuance*	10/84
Interpretation No. 1, *Demand Bonds Issued by State and Local Governmental Entities*—an Interpretation of NCGA Statement 1 and NCGA Interpretation 9	12/84
Statement No. 2, *Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457*	1/86
Statement No. 3, *Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*	4/86
Statement No. 4, *Applicability of FASB Statement No. 87, Employers' Accounting for Pensions, to State and Local Governmental Employers*	9/86
Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*	11/86
Statement No. 6, *Accounting and Financial Reporting for Special Assessments*	1/87
Technical Bulletin, *Applying Paragraph 68 of GASB Statement 3*	1/87
Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*	2/87
Concepts Statement No. 1, *Objectives of Financial Reporting*	5/87
Statement No. 8, *Applicability of FASB Statement No. 93, Recognition of Depreciation by Not-for-Profit Organizations, to Certain State and Local Governmental Entities*	1/88
Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*	9/89
Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*	11/89

Exhibit 4-1 *(cont.)*

Final Pronouncements as of July 1990

Title	*Date Issued*
Statement No. 11, *Measurement Focus and Basis of Accounting–Government Fund Operating Statements*	5/90
Statement No. 12, *Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers*	5/90
Statement No. 13, *Accounting for Operating Leases With Scheduled Rent Increases*	5/90

ACCOUNTING AND FINANCIAL REPORTING FOR RISK FINANCING AND RELATED INSURANCE ISSUES— GASB STATEMENT NO. 10

A public entity risk pool is a cooperative group of governmental entities that join together to finance an exposure liability, or risk, such as property and liability, workers' compensation, or employee health care. A pool may be part of a governmental entity which sponsors it or may be a stand-alone pool. Pools may be engaged in risk sharing, insurance purchasing, banking, or claims servicing.

The risks of loss included in the scope of the Statement are—

- Acts of God.
- Business interruption.
- Errors or omissions.
- Job related illnesses or injuries to employees.
- Other risks of loss of participating entities in a risk pool.
- Theft of, damage to, or destruction of assets.
- Torts.

Scope and Applicability of the Statement

GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues,* was issued in November

1989, to establish accounting and financial reporting standards for risk financing and insurance-related activities of state and local governmental entities and public entity risk pools.

Not covered by GASB Statement No. 10 are all postemployment benefits, liabilities that arise from breach of contract and similar actions, property tax appeals, and unemployment compensation claims.

The standard establishes requirements for public entity risk pools (pars. 17 through 51, 81) and for all state and local governmental entities (pars. 52 through 80, 82, and 83).

Public Entity Risk Pools

A major emphasis of Statement No. 10 is on pools in which there is some transfer or sharing of risks. But the standard requires that all pools account for their activities in an enterprise fund.

Accounting Requirements

The accounting principles to be followed by risk pools are generally similar to those prescribed in FASB Statement of Financial Accounting Standards (SFAS) No. 60, *Accounting and Reporting by Insurance Enterprises.*

Premium Revenue Recognition. Premiums or required contributions are generally recognized as revenue over the contract period proportionate to the amount of risk protection provided. This principle would also apply to premiums that are subject to adjustment, retrospectively rated, if the ultimate premium is reasonably estimable. If the retrospectively rated premium cannot be reasonably estimated, the cost recovery method or the deposit method should be used. If part of a premium is collected to cover future catastrophe losses, then that portion should be separately identified in pool equity if the amount is contractually or legally restricted for that purpose.

Claims Cost Recognition. Unpaid claims costs and estimates of costs related to incurred but not reported claims should be accrued when insured events occur for claims-made policies in the period of incurrence.

Claim accruals for incurred but not reported claims should be made if it is probable that a loss has been incurred and the amount can be reasonably estimated.

Claim adjustment expenses must be accrued when the related liability for unpaid claims is accrued. Such expenses include those directly associated with the adjustment of specific claims as well as those costs associated with the claims process.

Claims liabilities may be presented at discounted present values. Structured settlements, however, should be discounted at a settlement rate.

The purchase of an annuity contract may be treated as the complete liquidation of a claim if the likelihood that the pool will have to pay additional amounts is remote.

Disclosure of Loss Contingency. If a loss is not probable or the amount cannot be estimated, disclosure of a contingency is required if there is a reasonable possibility that a loss or an additional loss may have been incurred.

Acquisition Costs. Costs related to the acquisition of new contracts and renewal contracts (for example commissions, costs of underwriting, and policy issuing functions) should be capitalized and charged to expense as premiums revenue is recognized. Costs that do not vary with acquisition or are not related to acquisition (investment management, general administration, policy maintenance) should be expensed as incurred.

Dividends, Refunds, and Other Matters. Policyholder dividends should be estimated and accrued as an expense. If the dividends are used by policyholders to reduce premiums, they also must be reported as premium income. Experience refunds should also be accrued as a separate liability with a corresponding reduction of revenue.

GASB Statement No. 10 also discusses the accounting for premium deficiency (par. 36) and reinsurance (par. 37).

Investments. Accounting for investments is covered rather extensively in paragraphs 40 through 48, and may be summarized as follows:

Investments	*Valuation*
Bonds	Amortized cost**
To be held to maturity	
Trading	Market value*
Common and nonredeemable preferred stocks	Market value
Redeemable preferred stock	
To be held	Amortized cost**
To be traded	Market value*
Mortgage loans	Amortized cost less allowance for uncontrollable amounts
Real estate	Cost less accumulated depreciation and an allowance for any impairment in value
All other	Amortized cost less allowance for probable realized losses
Loan origination and commitment fees	See SFAS 91

*Temporary declines are recognized as unrealized gains or losses.

**If there is not permanent decline.

Realized gains and losses are included as a component of other income in the operating statement. Unrealized gains and losses should be reported as a separate component of equity. A write-down for a permanent decline creates a new cost basis.

Disclosures

Public entity risk pools should make the following disclosures (par. 49):

- A description of the risk transfer or pooling agreement, including the rights and responsibilities of the pool and the pool participants, as well as a brief description of the number and types of entities participating in the pool
- The basis for estimating the liabilities for unpaid claims and claim adjustment expenses, and a statement that the liabilities are based on the estimated ultimate cost of settling the claims, including the effects of inflation and other societal and economic factors

- The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period
- The face amount and carrying amount of liabilities for unpaid claims and claim adjustment expenses that are presented at present value in the financial statements and the range of annual interest rates used to discount those liabilities
- Whether the pool considers anticipated investment income in determining if a premium deficiency exists
- The nature and significance of excess insurance or reinsurance transactions to the pool's operations including reinsurance premiums ceded, and estimated amounts that are recoverable from reinsurers and that reduce the liabilities as of the balance sheet date for unpaid claims and claim adjustment expenses
- A reconciliation of total claims liabilities, including an analysis of changes in aggregate liabilities for claims and claim adjustment expenses for the current fiscal year and the prior fiscal year, in this tabular format:
  - — Amount of liabilities for unpaid claims and claim adjustment expenses at the beginning of each fiscal year
  - — Incurred claims and claim adjustment expenses:
    Provision for insured events of the current fiscal year
    Increase (decrease) in the provision for insured events of prior years
  - — Payments:
    Claims and claim adjustment expenses attributable to insured events of the current fiscal year
    Claims and claim adjustment expenses attributable to insured events of prior fiscal years
  - — Other (Provide an explanation of each material item.)
  - — Amount of liabilities for unpaid claims and claim adjustment expenses at the end of each fiscal year
- The aggregate outstanding amount of liabilities for which annuity contracts have been purchased from third parties in the claimants' names and the related liabilities that have been removed from the balance sheet (Annuity contracts used to settle claims for which the claimant has signed an agreement releasing the entity from further obligation and for which the likelihood

that the pool will be required to make future payments on those claims is remote should not be included in this disclosure.)

In addition, disclosure of revenue and claims development information covering a ten-year period is required as supplementary information (par. 50).

Entities Other Than Pools

State and local governments may manage and finance risks by purchasing commercial insurance, participating in a public entity risk pool, or retaining risks of loss. If a single fund is used to account for an entity's risk financing activities, it should be either the general fund or an internal service fund.

Participation in a pool may result in a transfer of risks to the pool, or the pool may simply act as as a claims servicing function. The accounting will vary according to the nature of the participation.

Accounting Requirements

The accounting requirements for entities other than pools are as follows:

Liability and Expenditure/Expense Recognition and Measurement. Unless the risks of loss have been transferred to an unrelated third party, state and local governmental entities should record an estimated loss if before the financial statements are issued it is probable that an asset has been impaired or liability has been incurred, and the amount of the loss can be reasonably estimated. This condition would also require that it is probable that one or more future events will occur confirming the loss. When the conditions indicate that the estimated loss falls within a range, and no amount within the range offers a better estimate than any other, the minimum amount should be accrued.

The recognition of a loss in these circumstances would apply to asserted claims as well as to incurred but not reported claims if it is probable that a claim will be asserted and the amount can be reasonably estimated. The liabilities should be based on the estimated ultimate cost of settling the claims.

Disclosure of Loss Contingency. If an accrual for a loss contingency is not made because one or both conditions for accrual are not met, then disclosure should be made of the loss contingency, including the estimated range of loss, if there is at least a possibility that a loss may have been incurred.

Discounting. Claims liabilities may be recorded at a discounted amount using the entity's settlement rate and giving consideration to its investment yield rate.

Annuity Contracts. If an annuity contract is purchased to satisfy a claim, then the liability and the annuity contract should be removed from the balance sheet if the likelihood of any additional payment is remote. Disclosure may still be necessary if the entity has not been released but remains contingently liable.

Investments. Investments related to an entity's risk financing activities, whether segregated or not, should be accounted for in the same way as other investments of the particular fund.

Disclosures

The following information should be disclosed in the notes to the financial statements, if applicable:

- A description of the risks of loss to which the entity is exposed and the way(s) in which those risks of loss are handled (for example, purchase of commercial insurance, participation in a public entity risk pool, risk retention)
- A description of significant reductions in insurance coverage from coverage in the prior year by major categories of risk. Also, indication whether the amount of settlements exceeded insurance coverage for each of the past three fiscal years
- If an entity participates in a risk pool, a description of the nature of the participation, including the rights and the responsibilities of both the entity and the pool
- If an entity retains the risk of loss—
  - — The basis for estimating the liabilities for unpaid claims
  - — The carrying amount of liabilities for unpaid claims that are presented at present value in the financial statements and the range of discount rates used to discount those liabilities
  - — The aggregate outstanding amount of claims liabilities for which annuity contracts have been purchased in the

claimants' names and for which the related liabilities have been removed from the balance sheet (Annuity contracts used to settle claims for which the claimant has signed an agreement releasing the entity from further obligation and for which the likelihood that the pool will be required to make future payments on those claims is remote should not be included in this disclosure.)

— A reconciliation of changes in the aggregate liabilities for claims for the current fiscal year and the prior fiscal year, in the following tabular format:

Amount of claims liabilities at the beginning of each fiscal year

Incurred claims, representing the total of a provision for events of the current fiscal year and any change (increase or decrease) in the provision for events of prior fiscal years

Payments on claims attributable to events of both the current fiscal year and prior fiscal years

Other (Provide an explanation of each material item.)

Amount of claims liabilities at the end of each fiscal year

Other Matters

GASP Statement No. 10 also covers the following:

- Risk retention entities other than pools
  - Use of the general fund
  - Use of an internal service fund
- Entities participating in public entity risk pools with transfer or pooling of risk
- Entities participating in public entity risk pools without transfer or pooling of risk
- Entities other than pools—insurance-related transactions
  - Claims-made policies
  - Retrospectively rated policies contracts
  - Policyholder or pool dividends
- Entities providing claims servicing or insurance coverage to others

REPORTING CASH FLOW FOR PROPRIETARY AND NONEXPENDABLE TRUST FUNDS AND GOVERNMENTAL ENTITIES THAT USE PROPRIETARY ACCOUNTING—GASB STATEMENT NO. 9

GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting,* issued in September 1989, establishes standards of reporting cash flows for governmental entities that measure net income and capital maintenance. GASB Statement No. 9 largely follows the provisions of SFAS 95, *Statement of Cash Flows.* GASB Statement No. 9 retains from SFAS 95—

- The focus on cash and cash equivalents.
- The definition of cash and cash equivalents.
- The general requirement to report gross amounts of cash receipts and cash payments.
- The optional use of the indirect method to report net cash flow from operations.
- The required disclosure of noncash investing, financing, and capital transactions.
- The language in SFAS 95.

The major differences between this Statement and SFAS 95 are—

- Four categories are used for classifying cash transactions instead of the three required by SFAS 95.
- The operating category is more narrowly focused.

Scope and Applicability of the Statement

GASB Statement No. 9 is applicable to—

- Proprietary and nonexpendable trust funds.
- Governmental entities that use proprietary fund accounting including public benefit corporations and authorities, governmental utilities, and governmental hospitals.

Statement No. 9 eliminates the requirement for public employee retirement systems and pension trust funds to provide a statement of changes in financial position, and they are also exempt from providing a statement of cash flows.

Requirements

To provide relevant information about the cash receipts and cash payments of an entity during a period, the Statement requires that a statement of cash flows should report the cash effects during the reported period of an entity's—

- Operating transactions.
- Noncapital financing transactions.
- Capital and related financing transactions.
- Investing transactions.

Investing, capital, and financing transactions that affect an entity's financial position but do not directly affect cash flows must also be reported.

The Statement also calls for a reconciliation of operating income (or net income if operating income is not separately identified on the operating statement) to net cash flow from operating activities.

Cash and Cash Equivalents The definition of cash equivalents is the same as in SFAS 95. But not all investments that are cash equivalents need to be so classified. Classification is subject to entity policy, which must be consistently applied, or in the event of a change, disclosed, with prior years presented being restated.

The GASB decided not to require the separate presentation of the flow of restricted cash and cash equivalents. The statement of cash flows must explain the change during the period in cash and cash equivalents regardless of whether there are restrictions on their use.

Gross and Net Cash Flows. Generally, the Statement requires the reporting of gross cash flows. Net cash flow reporting is acceptable for—

- Cash equivalents.
- Items whose turnover is quick, amounts large, and maturities short, including investments other than cash equivalents, loans receivable, and debt, provided the original maturity is three months or less.

- Purchases and sales of highly liquid investments, if substantially all of the governmental enterprise's assets were highly liquid investments and the governmental enterprise had little or no debt on average in relation to average assets.

Classification of Cash Receipts and Cash Payments

Cash receipts and cash payments should be classified as operating, noncapital financing, capital and related financing, or investing activities.

Cash Flows from Operating Activities

Cash inflows from operating activities include (par. 17)—

- Cash inflows from sales of goods or services, including receipts from collection of accounts receivable and both short- and long-term notes receivable from customers arising from those sales.
- Cash receipts from quasi-external operating transactions with other funds.
- Cash receipts from grants for specific activities that are considered to be operating activities of the grantor government. (A grant arrangement of this type is essentially the same as a contract for services.)
- Cash receipts from other funds for reimbursement of operating transactions.
- All other cash receipts that do not result from transactions defined as capital and related financing, noncapital financing, or investing activities.

Cash outflows from operating activities include (par. 18)—

- Cash payments to acquire materials for providing services and manufacturing goods for resale, including principal payments on accounts payable and both short- and long-term notes payable to suppliers for those materials or goods.
- Cash payments to other suppliers for other goods or services.
- Cash payments to employees for services.

- Cash payments for grants to other governments or organizations for specific activities that are considered to be operating activities of the grantor government.
- Cash payments for taxes, duties, fines, and other fees or penalties.
- Cash payments for quasi-external operating transactions with other funds, including payments in lieu of taxes.
- All other cash payments that do not result from transactions defined as capital and related financing, noncapital financing, or investing activities.

Note that interest payments are classified as either capital or noncapital financing activity outflows, interest received as investing activity inflows, and subsidies received to finance operating deficits as noncapital financing activity inflows. But interest income from program loans is an operating activity.

The GASB prescribed the classification of certain activities as follows (par. 60):

Cash Flow	*Category*
Proceeds from financing to start up loan program	Noncapital financing
Disbursement of loan funds to students	Operating activities
Routine operating expenses	Operating activities
Collection of loans (principal and interest)	Operating activities
Debt service payments (principal and interest)	Noncapital financing

Paragraph 19 points out that cash flows from operating activities also include transactions of certain loan programs undertaken to fulfill a governmental responsibility. These "program loans" are made and collected as part of a governmental program, for example, low-income housing mortgages or student loans. For cash flow reporting purposes, these loan activities are the operating activities of the governmental enterprise; therefore, the related cash flows should be classified as operating activities. All loans made and collected (including interest) should be considered operating cash outflows and inflows, respectively. Any proceeds from bonds issued to finance the loan program and subsequent debt service payments (principal and interest) should be classified as noncapital financing activities.

Cash management pools that are used as demand deposit accounts should be treated as cash. Those pools that are not used as demand deposits (revenue bond reserve investment pools) should be treated as an investing activity.

Cash Flows from Noncapital Financing Activities

Cash flows from noncapital financing activities include borrowings for purposes other than to acquire, construct, or improve capital assets and repayments, including interest. This category is less significant for governmental agencies because they do not engage in financing transaction with owners.

Cash inflows include (par. 21)—

- Proceeds from issuing bonds, notes, and other short- or long-term borrowing not clearly attributable to acquisition, construction, or improvement of capital assets.
- Cash receipts from grants or subsidies except (1) those specifically restricted for capital purposes (par. 24b) and (2) those for specific activities that are considered to be operating activities of the grantor government (par 17c).
- Cash received from other funds except (1) those amounts that are clearly attributable to acquisition, construction, or improvement of capital assets (par. 24c), (2) quasi-external operating transactions (par. 17b), and (3) reimbursement for operating transactions (par. 17d).
- Cash received from property and other taxes collected for the governmental enterprise and not specifically restricted for capital purposes.

Cash outflows include (par. 22)—

- Repayments of amounts borrowed for purposes other than acquiring, constructing, or improving capital assets.
- Interest payments to lenders and other creditors on amounts borrowed or credit extended for purposes other than acquiring, constructing, or improving capital assets.
- Cash paid as grants or subsidies to other governments or organizations, except those for specific activities that are considered to be operating activities of the grantor government (par. 18d).

- Cash paid to other funds, except for quasi-external operating transactions.

Cash Flows from Capital and Related Financing Activities

Cash inflows from capital and related financing activities include (par. 24)—

- Proceeds from issuing or refunding bonds, mortgages, notes, and other short- or long-term borrowing clearly attributable to the acquisition, construction, or improvement of capital assets.
- Receipts from capital grants awarded to the governmental enterprise.
- Receipts from contributions made by other funds, other governments, and other organizations or individuals for the specific purpose of defraying the cost of acquiring, constructing, or improving capital assets.
- Receipts from sales of capital assets: also, proceeds from insurance on capital assets that are stolen or destroyed.
- Receipts from special assessments of property and other taxes levied specifically to finance the construction, acquisition, or improvement of capital assets.

Cash outflows from capital and related financing activities include (par. 25)—

- Payments to acquire, construct, or improve capital assets.
- Repayments or refundings of amounts borrowed specifically to acquire, construct, or improve capital assets.
- Other principal payments to vendors who have extended credit to the governmental enterprise directly for purposes of acquiring, constructing, or improving capital assets.
- Cash payments to lenders and other creditors for interest directly related to acquiring, constructing, or improving capital assets.

Incorporating a separate activity for "capital and related financing" results in the following modifications to SFAS No. (par. 57):

- Construction and acquisition of capital assets are not classified as investing as specified in SFAS 95; instead, they are major elements in the capital and related financing category.

- The financing category in SFAS 95 includes cash inflows and outflows related to both capital and noncapital borrowing. Capital borrowing activity is another major element of the capital and related financing category.
- To show the complete picture of all cash inflows and outflows from financing, acquiring,and disposing of capital assets, it is necessary to include interest payments in this category rather than in the operating category.
- Similarly, interest on noncapital debt is classified as noncapital financing so that it is treated consistently with capital interest and gives a more complete picture of all inflows and outflows arising from noncapital debt transactions.
- The nature of investing activity in the governmental environment is focused on the acquisition and disposition of debt and equity instruments of other entities rather than on the investment of ownership capital in capital assets. Therefore, it is more useful to reclassify investment earnings (interest and dividends) as inflows from investing rather than from operating activities. This presents a clearer picture of all the cash flows from investing activities and is consistent with the reclassification of interest expense discussed earlier.

Cash Flows from Investing Activities

Investing activities include making and collecting loans (except program loans, see operating activities) and acquiring and disposing of debt or equity instruments.

Cash inflows from investing activities include (par. 27)—

- Receipts from collections of loans (except program loans) made by the governmental enterprise and sales of other entities' debt instruments (other than cash equivalents) that were purchased by the governmental enterprise.
- Receipts from sales of equity instruments and from returns of investment in those instruments.
- Interest and dividends received as returns on loans (except program loans), debt instruments of other entities, equity securities, and cash management or investment pools.
- Withdrawals from investment pools that the governmental enterprise is not using as demand accounts.

Cash outflows from investing activities include (par. 28)—

- Disbursements for loans (except program loans) made by the governmental enterprise and payments to acquire debt instruments of other entities (other than cash equivalents).
- Payments to acquire equity instruments.
- Deposits into investment pools that the governmental enterprise is not using as demand accounts.

Distinguishing Between Capital and Noncapital Financing

Paragraph 29 of the Statement provides the following guidance for distinguishing between capital and noncapital financing:

- Debt that is not clearly attributable to capital construction, acquisition, or improvement should be considered noncapital debt, and the debt proceeds and subsequent payments of principal and interest should be classified as noncapital financing.
- Principal and interest payments on debt that was issued to acquire, construct, or improve capital assets that have been sold or otherwise disposed of should remain classified as capital and related financing.
- In a defeasance of debt, the proceeds of a refunding debt issue used to refund capital debt should be reported as a cash inflow in the capital and related financing category, and the payment to defease the existing capital debt should be reported as an outflow in that category. Similarly, subsequent principal and interest payments on the refunding debt should also be reported as cash outflows in the capital category. If the refunding issue is in excess of the amount needed to refund the existing capital debt, the total proceeds and the subsequent principal and interest payments should be allocated between the capital category and the noncapital financing category based on the amounts used for capital and noncapital purposes.

Content and Form of a Statement of Cash Flow

The statement of cash flows must report net cash provided or used for each of the four categories and reconcile the change in cash and cash equivalents.

Under the direct method of reporting operating cash flows, which is optional, the following details are required (par. 31):

- Cash receipts from customers
- Cash receipts from quasi-external operating transactions with other funds
- Other operating cash receipts, if any
- Cash payments to other suppliers of goods or services
- Cash payments to employees for services
- Cash payments for quasi-external operating transactions with other funds, including payments in lieu of taxes
- Other operating cash payments, if any

An illustrative statement of cash flows appearing in Appendix B of GASB Statement No. 9 is reproduced as Exhibit 4-2 with the permission of the GASB.

Exhibit 4-2 *Illustrative Statement of Cash Flows*

75. This appendix provides sample financial statements to illustrate the preparation of a statement of cash flows for **a hypothetical water and sewer enterprise fund.** The illustrative statement of cash flows and supplemental information are prepared **using the direct method and reconciling to operating income rather than net income.** The indirect method could be illustrated by either substituting the data in the "Reconciliation of operating income to net cash provided by operating activities" for the data in the "Cash flows from operating activities" section of the statement of cash flows or by presenting "Net cash provided by operating activities" as a single line on the statement of cash flows and the detail (the reconciliation) as a separate schedule. Also included in this [illustration] are **a comparative balance sheet** for the water and sewer fund; **a statement of revenues, expenses, and changes** in retained earnings; and **two paragraphs with explanatory details coded for easy reference.** The changes in the balance sheet amounts for the year are explained and coded* in paragraph 76 to provide a crosswalk to the statement

*The letters (A–N) correspond to the coding on the statement of cash flows and the reconciliation of operating income to net cash provided by operating activities; the numbers (1–14) correspond to the coding on the balance sheets.

Governmental Accounting Standards Board Statement No. 9, "Reporting Cash Flow for Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Accounting," (Norwalk, Conn: GASB 1989). Reprinted with permission.

Exhibit 4-2 *(cont.)*

of cash flows. Paragraph 77 reconciles certain operating statement amounts with corresponding amounts in the statement of cash flows. These illustrative statements are intended as examples only and may provide more or less detail than is most useful for a particular governmental enterprise.

Water and Sewer Fund
Statement of Cash Flows for the Year Ended June 30, 19X2
Increase (Decrease) in Cash and Cash Equivalents

Cash flows from operating activities:		
Cash received from customers	$ 912,000	
Cash payments to suppliers for goods and services	(450,000)	
Cash payments to employees for services	(300,575)	
Payment in lieu of taxes	(50,000)	
Other operating revenues	15,075	
Net cash provided by operating activities		$ 126,500
Cash flows from noncapital financing activities:		
Net borrowings (repayments) under revolving loan arrangement	$ (20,000)[J]	
Interest paid on revolving loan	(1,500)[I]	
Operating grants received	100,000	
Operating transfers-out to other funds	(75,000)	
Net cash provided by noncapital financing activities:		3,500
Cash flows from capital and related financing activities:		
Proceeds from sale of revenue bonds	$ 250,000[L]	
Acquisition and construction of capital assets	(350,000)[F]	
Principal paid on revenue bond maturities and equipment contracts	(75,000)[K,M]	
Interest paid on revenue bonds and equipment contracts	(33,500)[H]	
Proceeds from sale of equipment	10,000	
Capital contributed by subdividers	60,000[N]	

Exhibit 4-2 ***(cont.)***

Net cash used for capital and related financing activities		(138,500)
Cash flows from investing activities:		
Purchase of investment securities	$(125,000)[C]	
Proceeds from sale and maturities of investment securities	75,000[D]	
Interest and dividends on investments	9,000[E]	
Net cash used in investing activities		(41,000)
Net decrease in cash and cash equivalents		(49,500)
Cash and cash equivalents at beginning of year		175,600
Cash and cash equivalents at end of year		$ 126,100

Reconciliation of Operating Income to Net Cash Provided By Operating Activities:

Operating income (loss)		$(110,500)
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	$ 245,000	
Provision for uncollectible accounts	2,000[B]	
Change in assets and liabilities:		
Increase in accounts receivable	(15,000)[A]	
Decrease in inventory	2,000	
Decrease in prepaid expenses	500	
Increase in accounts payable	2,500	
Total adjustments		237,000
Net cash provided by operating activities		$126,500

Noncash Investing, Capital, and Financing Activities:

Shortly before the balance sheet date, the Water and Sewer Fund entered into a time-pay agreement to purchase office equipment costing $7,500. There was no down payment and no monthly installments were made before year-end.

Exhibit 4-2 ***(cont.)***

Disclosure of Accounting Policy:

For purposes of the statement of cash flows, the Water and Sewer Fund considers all highly liquid investments (including restricted assets) with a maturity of three months or less when purchased to be cash equivalents. (*Note:* This disclosure should be included in the summary of significant accounting policies.)

Water and Sewer Fund
Balance Sheets

	6/30/X2	*6/30/X1*	*Change*
Assets:			
Cash and cash equivalents	$ 125,100	$ 173,100	$ (48,000)
Customer accounts receivable (net of allowance for uncollectibles of $7,500 and $5,500)	96,500	83,500	13,000[2]
Inventory	46,000	48,000	(2,000)[3]
Prepaid expenses	600	1,100	(500)[3]
Restricted assets:			
Cash and cash equivalents	1,000	2,500	(1,500)[1]
Investments	110,000	60,000	50,000[4]
Interest receivable	1,000	1,500	(500)[5]
Property, plant, and equipment, at cost	7,066,200	6,714,200	352,000[6]
Accumulated depreciation	(3,238,000)	(2,995,000)	(243,000)[7]
Property, plant, and equipment, net	3,828,200	3,719,200	109,000
Total assets	$4,208,400	$4,088,900	$ 119,500
Liabilities:			
Accounts payable and accrued expenses	$ 68,000	$ 65,500	$ 2,500[3]
Accrued interest payable	1,250	750	500[8]
Revolving loan	3,000	23,000	(20,000)[9]
Equipment contracts payable	7,500	10,000	(2,500)[10]
Revenue bonds	575,000	390,000	185,000[11]
Total liabilities	$ 654,750	$ 489,250	$ 165,500

Exhibit 4-2 *(cont.)*

	6/30/X2	*6/30/X1*	*Change*
Fund equity:			
Contributed capital	$1,795,000	$1,915,000	$(120,000)[12]
Reserved retained earnings	112,000	64,000	48,000[13]
Unreserved retained earnings	1,646,650	1,620,650	26,000[14]
Total fund equity	$3,553,650	$3,599,650	$ (46,000)
Total liabilities and fund equity	$4,208,400	$4,088,900	$ 119,500

Water and Sewer Fund
Statement of Revenues, Expenses, and Changes in Retained Earnings
for the Year Ended June 30, 19X2

Operating revenues:		
Water sales	$695,250	
Sewer charges	231,750	
Other operating revenues	15,075	
Total operating revenues		$ 942,075
Operating expenses:		
Costs of sales and services	$507,300	
Administration	250,275	
Payment in lieu of taxes	50,000	
Depreciation	245,000	
Total operating expenses		1,052,575
Operating income (loss)		$ (110,500)
Nonoperating revenues (expenses):		
Interest income	$ 6,500	
Interest expense	(28,000)	
Gain on sale of equipment	1,000	
Operating grants	100,000	
Net nonoperating revenues (expenses)		79,500
Net income (loss) before operating transfer		(31,000)
Transfers to other funds		(75,000)
Net income (loss) for the year		(106,000)
Add back depreciation on assets acquired with capital grants		180,000
Increase in retained earnings		74,000
Retained earnings—beginning of year		1,684,650
Retained earnings—end of year		$ 1,758,650

76. The following information provides the details to the changes in the balance sheet amounts. The letters (A–N) correspond to the coding on the statement of cash flows and the reconciliation of operating income to net cash provided by operating activities; the numbers (1–14) correspond to the coding on the balance sheets.

1. Net changes in cash and cash equivalents			
2. Increase in customer receivables		$ 15,000[A]	
Increase in allowance for uncollectibles		(2,000)[B]	
		$ 13,000	
3. Simple increase (decrease)—traces directly to the reconciliation of operating income to net cash provided by operating activities			
4. Purchase of investments		$ 125,000[C]	
Sales and maturities		(75,000)[D]	
		$ 50,000	
5. Interest earned		$ 8,500	($6,500 revenue, $2,000 capitalized)
Interest received		(9,000)[E]	
		$ (500)	
6. Acquisition and construction		$ 357,500	($350,000 cash paid,[F] $7,500 time-pay)
Cost of equipment sold		(11,000)	
Net construction period interest:			
Expense	$7,500		
Income	(2,000)	5,500	
		$ 352,000	
7. Depreciation expense		$ 245,000[G]	
Accumulated depreciation on equipment sold		(2,000)	
		$ 243,000	
8. Interest accrued		$ 35,500	($28,000 expense, $7,500 capitalized)
Interest paid		(35,000)	($33,500[H] capital, $1,500[I] noncapital)
		$ 500	

Exhibit 4-2 ***(cont.)***

9.	Short-term borrowing	$ 5,000	
	Repayments	(25,000)	
		$ (20,000)[J]	(qualifies for "net" reporting)
10.	New contracts	$ 7,500	
	Installments on old contracts	(10,000)[K]	
		$ (2,500)	
11.	New bonds sold	$ 250,000[L]	
	Principal payments made	(65,000)[M]	
		$ 185,000	
12.	Subdivider contribution received	$ 60,000[N]	
	Depreciation of assets bought with contributed capital	(180,000)	
		$(120,000)	
13.	Decrease in restricted cash and cash equivalents	$ (1,500)	
	Increase in restricted investments	50,000	
	Decrease in restricted interest receivable	(500)	
	Net increase in restricted assets	$ 48,000	
14.	Net loss for the year	$(106,000)	
	Depreciation expense charged against contributed capital	180,000	
	Net increase in reserves	(48,000)	
		$ 26,000	

77. The following information is provided as a reconciliation between certain amounts reported in the statement of cash flows and the amounts in the statement of revenues, expenses, and changes in retained earnings:

Water sales	$695,250
Sewer charges	231,750
Plus beginning receivables	89,000
Less ending receivables	(104,000)
Cash received from customers	$912,000

Exhibit 4-2 *(cont.)*

Cost of sales and services	$507,300
Administration	250,275
Plus:	
Allowance for uncollectibles, 6/30/X1	5,500
Inventory, 6/30/X2	46,000
Prepaids, 6/30/X2	600
Accounts payable, 6/30/X1	65,500
Less:	
Allowance for uncollectibles, 6/30/X2	(7,500)
Inventory, 6/30/X1	(48,000)
Prepaids, 6/30/X1	(1,100)
Accounts payable, 6/30/X2	(68,000)
Cash paid to suppliers and employees	$750,575
Less cash paid to employees	(300,575)
Cash paid to suppliers	$450,000
Proceeds from sale of equipment	$ 10,000
Cost of equipment sold	(11,000)
Accumulated depreciation on equipment sold	2,000
Net gain on sale	$ 1,000

MEASUREMENT BASIS AND FOCUS OF ACCOUNTING—GOVERNMENT FUND OPERATING STATEMENTS—GASB STATEMENT NO. 11

Scope of Statement

Areas Covered

The statement establishes a measurement focus and basis of accounting for governmental and expendable trust fund operating statements. The statement also provides guidance for balance sheet reporting of general long-term capital debt. A follow-up statement will integrate this pronouncement into the codification.

Measurement Focus. Measurement focus is what is being expressed in a governmental entity's financial statements. To determine what is expressed requires identification of which resources are measured and when they are recognized.

Basis of Accounting. When the effects of transactions and events are recognized, this is referred to as basis of accounting.

Areas Not Changed

Measurement and recognition issues within governmental fund operating statements for pension expenditures; other postemployment benefits; special termination benefits; claims and judgments and related insurance transactions; capital improvement special assessment transactions; intergovermental grants, entitlements, and shared revenues, operating revenues from nonexchange transactions; and debt service expenditures on general long-term capital debt are being considered in several related projects. Recognition and measurement guidance formulated within GASB Statement No. 11 should provide a basic framework for those projects. Guidance for balance sheet reporting of other liabilities arising from operations of government funds will be addressed in a subsequent statement on financial reporting.

Effective Date and Transition

GASB Statement No. 11 is effective June 15, 1994. Early application is not permitted. Transaction requirements will be set forth in a future statement.

General Principles Behind Measurement Focus

Focus on Flow of Financial Resources

The pronouncement requires that governmental funds measure the extent to which financial resources obtained during a period are sufficient to cover claims incurred during a period against financial resources. This is referred to as a flow of financial resources measurement focus. This is different from present practice, which uses the flows of only *current* financial resources as the measurement focus of government funds. Financial resources are cash, claims to cash, debt securities of another entity, claims to goods and services, inventories, supplies, and equity securities of another entity obtained as a result of past transactions or events.

Uses of Accrual Basis of Accounting

The effects of past transactions or events on financial resources are recognized when they take place. There is no requirement of receipt of payment of cash. This is a significant departure from the current modified accrual basis, which defies recognition of many transactions whose cash effect does not take place until some point in the future.

Using an accrual basis assists in the determination of whether current year revenues are sufficient to pay for current year services, thereby enhancing interperiod equity among taxpayers by encouraging the matching of the tax levy and other revenues with the full cost of services.

Impact on Financial Statements

The application of flow of "all financial resources" measurement focus results in recording of transactions affecting revenues, operating expenditures, and interfund operating and residual equity transfers when the transactions or events that affect financial resources take place. Similarly, applying the general principles impacts recording of transactions and events related to the acquisition, disposition, and long-term financing of capital assets and long-term financing of certain nonrecurring activities.

Long-term debt financing of operations continues not to be reported in the operating statement, even though transactions and events affecting financial resources occur. General fixed assets account group (GFAAG) and general long-term debt account group (GLTDAG) continue to be reported as account groups, separate from the governmental funds.

Recognition of Revenues

Revenues are to be recognized when the underlying event or transaction that increases financial resources takes place and the government has a claim to an asset. This does not depend on the receipt of cash. Receivables are ordinarily reported at the same time as revenue is recognized. Amounts due or collected before revenue recognition criteria are met are reported as deferred revenue. Receivables should be reduced by the estimate for amounts uncollectible.

Existing Practices

The revenue recognition policies under GASB Statement No. 11 are a change from current practice, which National Council of Governmental Accounting (NCGA) Statement 1 sets forth as:

Revenues and other governmental fund financial resource increments (e.g., bond issue proceeds) are recognized in the accounting period in which they become susceptible to accrual—that is, when they become both measurable and available to finance expenditures of the fiscal period. Available means collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period.

Source of Governmental Revenues

Governmental revenues result from taxation, other nonexchange transactions or events, and exchange transactions. Examples of nonexchange transactions include fines, fees, licenses and permits, and donations. Exchange transactions involve charges for services, lease revenue for property use, and investments. Rules for recognition will differ depending on the source of revenue.

Tax Revenue Recognition Criteria. Tax revenue should be recognized when—

- The underlying transaction or event has taken place.
- The government has demanded the taxes from the taxpayer by establishing a due date on or before the end of the period.

Administrative Lead Time. If taxpayer-assessed taxes are due within two months after the end of the period to provide an administrative lead time for taxpayers to make calculations, the revenues are still considered to be demanded as of the end of the period.

Accrual of Delinquent Taxes. An accrual is to be made for taxes due but not received (i.e., delinquent taxes). The delinquency accrual is for amounts late in reporting or payment but does not include estimates of amounts due from taxpayer noncompliance. The accrual is based on—

- Amounts received in cash before the financial statements are issued.
- Amounts reported but not received before the statements are issued.
- Amounts expected to be reported after the issuance of financial statements based on historical trends. (Historical trends should be adjusted for structural changes such as in tax rates.)

No delinquency accrual should be made for unreported or underreported income that will be discovered through tax audits. Amounts uncovered through audits should be accrued if the tax is assessed before issuance of the financial statements.

Current Final Settlement Amounts. Additional payments and refunds to settle taxpayer-assessed taxes are final settlements. Current final settlements are those settlements relating to a tax period on or before the governmental unit's fiscal year-end, and the final settlement is due within two months after year-end. Revenue should be accrued for current final settlements.

Accrual for Current Final Settlements. The accrual for current final settlements is based on:

- Amounts received or paid before the financial statements are issued.
- Amounts reported but not received or paid before the financial statements are issued.
- Amounts expected to be reported based on historical trends of delinquent final settlements filings. (Trends are adjusted for changes in tax law, economic conditions, and so forth.)

Final Future Settlements. Future settlements are additional payments and refunds that relate either to tax periods ending after the current fiscal year or relate to a taxable period on or before the current fiscal year but are due more than two months after the current fiscal year. Estimates of future final settlements should not be recognized, but a reduction for overdemand may have to be recognized.

Overdemand for Tax Payments. Where government has an overpayment (i.e., overdemand) for taxes through tax withholdings or estimated payments, revenue is to be reduced and a liability reported for the overdemand subject to final settlement. No revenue is to be accrued where there is underdemand through the systems for withholdings taxes and collecting estimated taxes.

Interest, Penalties, and Uncollectibles. Interest on unpaid taxes should be recognized as it accrues over time, and penalties should be recognized when assessed. Allowances for uncollectible amounts should be set up.

Specific Application of Revenue Recognition Rules

Sales Taxes

To recognize revenue from sales taxes, the following must have occurred:

- The sale has taken place.
- The government has demanded the taxes.

Taxes are considered demanded if they are due within two months after the end of the period. The two conditions taken together are evidence the governmental unit has obtained financial resources regardless of when cash is received, subject to an appropriate allowance for uncollectibles.

The following guidance should assist in the preparation of the sales tax revenue accrual and the recognition of receivables and refund liability.

Delinquency Accrual. The delinquency accrual is to be based on current sales taxes reported but not received, current amounts received in cash after the due date, and amounts expected to be reported after financial statements are released ("trickle in") after the due date based on historical trends.

Audit Adjustments for Unreported Sales. Sales tax revenue should be adjusted for those audit adjustments that are billed during the period as well as those made after the period but before financial statements are issued. No portion of the accrual is to be based on estimates.

Refund Liabilities. Although sales taxes are not typically subject to final settlement, sales tax revenue is reduced for refunds and a liability is set up.

Interest and Penalties on Unpaid Taxes. Interest on unpaid taxes is recognized as revenue as it accrues over time and penalties are recognized as assessed.

Uncollectibles. Sales tax revenues are reduced by an estimate for allowance for uncollectibles.

Case 1: Illustration of revenue recognition rules for sales taxes

Rainy State has a June 30 19X0 fiscal year-end. Its report is typically issued September 30, and its accrual cut-off date is August 31. The following information is available for Rainy State sales tax collection:

1. Filing. Merchants with sales tax remittances in excess of $3,000 annual must remit fifteen days after the end of the month of sale, while smaller merchants file quarterly, no later than sixty days after the end of the quarter. Timely cash collections are as follows:*

	Fiscal Year Ending June 30, 19X0	*Month of July 19X0*	*Month of August 19X0*
Timely sales Tax collections (000's)	$4,000*	$1,000	$280

*Disregard all reversals of opening balances.

2. Delinquencies

- Cash receipts in July for 19X0 delinquent taxes are $160.
- Returns filed on time with no tax collected $30. Using historical estimates, $10 will be collected in the new fiscal year for 19X0 sales tax returns not yet filed but due.
- $5 accrued interest through June 30 and $2 in July and August for 19X0 sales taxes (Assume opening balances are already reversed.)

3. Audit Adjustments. Typically, assessments for underpayments are 3 percent of cash collections. $100 was assessed thru June 30, 19X0 and $25 in July 19X0 for 19X0 sales taxes. $5 in total penalties (of which $3 was in July X0) were assessed for 19X0 underpayment.

The case demonstrates the calculation of the revenues to be recognized from sales taxes.

Timely cash collections		$5,280
+ Delinquencies		
Cash received in July	$160	
Uncollected taxes/returns filed	30	
Expected collections returns not filed	10	
Accrued Interest—through 6/30/X0	5	205
+ Audit Adjustments		
Actual Assessments	$125	
Penalties Assessed Through 6/30/X0	2	127
Accrued sales tax/interest revenue		$5,612

Income Taxes

To recognize revenue from income taxes, both corporate and individual, the following must have occurred:

- Related income is earned by the taxpayer.
- The government has demanded the taxes.

Income taxes are considered as demanded if due within two months after the end of the period, regardless of whether cash is collected. Administrative lead time for taxes includes the time allowed employers to remit amounts withheld from employees' wages.

The following guidance should assist in the preparation of the income tax revenue accrual, receivables, and refund liabilities.

Delinquent Withholdings and Estimated Taxes. The accrual for delinquent withholding and estimated payments is based on delinquent amounts received before financial statements are issued, amounts reported but not received before financial statements are issued and amounts determined using past historical trends that are expected to trickle in after the financial statements are issued.

Current Final Settlements. Current final income tax settlements are for taxable periods relating to the current fiscal year-end and are demanded within two months of year-end. The accrual should be made for income tax receipts or refunds received or disbursed before financial statements are issued, amounts reported but not received or paid before the financial statements are issued, and amounts based on historical trends relating to delinquent final settlement filings that are expected to be paid.

Revenue Reduction for Overdemand. Income tax revenues should be reduced where built into the income tax withholding or estimated payment system is an excess payment requirement. Structural underdemand through underwithholdings or underpayments of estimated taxes are not recognized. Revenue is not reduced for overdemand through taxpayer actions. For instance, there is no accrual for over-withholding of estimated taxes because taxpayers do not designate appropriate number of dependents.

Audit Adjustments for Underreported Income. An accrual should be made for actual audit assessments during the fiscal year or after the fiscal year but before the financial statements are issued.

Interest and Penalties on Unpaid Taxes. Interest is accrued over time and penalties are recognized when assessed.

Uncollectibles. An allowance for uncollectibles is to be setup.

Taxpayer-Assessed Taxes Administered or Collected by Another Government

Where taxpayer-assessed taxes are imposed by a unit different from the one collecting the taxes and insufficient information is available to make the appropriate accruals, the taxing government should include in revenue the cash received (reduced by amounts recognized as revenue in previous periods) plus cash received within one month after the period (less previously recognized amounts). If reliable information is available, cash received more than one month after the period that is attributable to the events and transactions occurring in the current fiscal period can also be recognized.

Case 2: Income tax accrual

The following case demonstrates the income tax accrual for 19X5 for Sunshine State. The state has a June 30 fiscal year-end, and there is a requirement that the state file its financial report by October 15 following its fiscal year-end. The state uses September 30 as the cut-off date for making accruals. The case is broken up so that components of the accruals are derived separately.

Part A: Calculation of Accrual For Estimated Withholding and Estimated Payments. Assume that

- Employers remit amounts of withheld taxes monthly by the fifteen day of the following month.
- Individuals file estimated taxes on April 15th, June 15th, September 15, and December 31 for one quarter of the difference between estimated tax and amounts withheld.
- Individual must file a tax return no later than April 15 of the year following the tax year and pay any amounts owed.

	*Collections**	
Period	*Estimated Taxes*	*Withholding Tax*
7/1/X4–6/30/X5	$2,000	$4,000
Through 7/31/X5 for June withholdings		200
Through August 19X5 for June withholdings		100
Filed thru 9/30X5 without payment		90
Receipts through 9/14/X5 for June 15 due date	250	
Historical experience of Estimated Payments due June 15 not made by September 14 that will be paid later	0	
	$2,250	$4,390

*Disregard opening balance reversals.

Part A of this case illustrates the accrual for estimated withholdings and estimated payments. The accrual includes withholdings and estimated payments due and received for taxes earned during the fiscal year, withholding and estimated for taxes earned and collected within two months after the fiscal years to allow for administrative lead time, estimated withholdings filed without payment, and delinquent estimated payments for June 15 received before September 14. The amount to be accrued is $2,250 in estimated taxes and $4,390 in withholdings.

Part B: Calculation of Final Settlements, Additional Payments, and Refunds Overdemand and Audits. Assume that between January 1 and June 30, 19X5, taxpayers paid additional amounts of reported tax liabilities of $750 and over the same period taxpayers claimed refunds of $650 for calendar year 19X4. Between July and Sept 30, 19X5, taxpayers paid additional amounts or reported liabilities of $160 for calendar year 19X4 and taxpayers claimed refunds of $100 for 19X4. Historical experience shows $20 will trickle in and $10 in refunds will be paid after September 30 for delinquent settlements. A 5-percent overwithholding for the period January 1, 19X5 to June 30, 19X5, subject to final settlement on April 15, 19X6, was $70. Because of the strong economy, it is expected that future settlements for 19X5 to be collected in 19X6 will be $150 higher than usual. Audits of 19X4 personal tax returns result in collections of $80 through June 30, 19X5, $25 collected through September 30, 19X5, and $35 in agreements to pay past taxes but not yet collected as of September 30, 19X5. Thirty-three dollars is expected in collections from future audits.

Part B of this case illustrates the accrual for current final settlements overdemand and future settlements.

The income tax accrual is adjusted for current final settlements. This includes amounts paid or refunded before the statements are issued, plus amounts expected to be reported based on historical trends.

The accrual for current final settlement is as follows:

Payments received before statements issued	$910
Refunds made before statements issued	(750)
Historical experience net payments	10
	$170

The accrual for income tax revenue is reduced by excess payments requirements built into the withholding and estimated payments system. This totals $70; underwithholdings are not recognized.

No accrual is permitted under GASB Statement No. 11 for taxes expected to be received through final settlement payments expected to be recognized in future periods.

Gross income is adjusted for unreported income from audits for amounts collected before financial statements are issued as well as amounts assessed. No adjustment is made for expected results from future audits. The accrual is $140 ($80 + $25 + $35).

Property Taxes

Revenues from property (ad valorem) taxes are recognized in the period for which the tax is levied, provided taxes are demanded during the year. Cash need not be collected.

Determination of Demand Date. The demand date is the due date, which is the last date before interest and penalties accrue. Receivables are recorded when property taxes are due. Deferred revenues are credited, and a receivable or cash is debited for property taxes received or receivable before the budgetary period for which the tax is levied. Where property taxes are due after the budgetary period for which they are levied, the revenue is recognized in the period property taxes are due.

Abatements and Foreclosures. Property tax revenue should be reduced by an allowance for uncollectibles.

Property Tax Disclosures. The following disclosures are required:

- Levy dates
- Lien dates
- Due dates
- Past due or delinquent dates

Other Taxes

Revenues, receivables, and refund liabilities are recognized on an accrual basis using the general and specific guidance for taxes.

Case 3: Recognition of revenue from property taxes

Delightful City levies a property tax of $1 million on June 1, 19X8 covering the budgetary period July 1, 19X8 through June 30, 19X9. Taxes are due July 31, 19X8 and January 15, 19X9. Fiscal year-end is June 30, 19X9. The financial statements are issued September 30, 19X9. The accrual cut-off date is August 15, 19X9. A schedule of collections is as follows ($000):

	6/19X8	*7/1/–12/31 19X8*	*1/X9–6/30/X9*	*7/X9–8/15/X9*
Collections	$25	$470	$430	$20

Tax abatements (forgiveness) were	$30
Uncollectible taxes after foreclosures	20
Delinquent taxes expected to be collected (September)	5
Interest accrued through 6/30/X9	3

This case shows the revenue to be recognized by Delightful City for the year ended June 30, 19X9. Property tax revenue is recognized in the period for which the tax is levied, provided taxes are demanded in the year. One million dollars demanded through the period ending 6/30/X9. These revenues are reduced by abatements and uncollectible taxes. Interest income of $3 is picked up in the period it accrued. Total revenue attributable to property taxes is $953. Notice that, in effect, the $5 of delinquent taxes expected to be collected are accrued.

Property tax revenue	
Levy and due for 7/1/X8–6/30/X9	$1,000
Less: Uncollectible taxes	−20
Less: Abatements	−30
Plus: Accrued interest	3
Total	$ 953

Specific Guidance for Recognition of Nonexchange Revenue

Unless specific guidance is provided, other nonexchange revenues should be recognized when the event takes place and there is an enforceable legal claim to the amounts. Receipt of cash is not required for recognition.

Fines

Fines should be recognized when there is a legal enforceable claim. An allowance should be recorded for uncollectible fines. A claim is legally enforceable if—

- The claim can no longer be contested and is automatically imposed. Or—

- The fine is paid prior to the court date. Or—
- The fine is imposed by the court.

If the accrual basis is impractical, a cash basis can be employed.

Permits and Licenses

Revenue on licenses and fees is recognized when an enforceable legal claim exists. Ordinarily, this occurs when the fees are due, and there is no right to a refund. Alternatively, the governmental unit can elect to allocate fees over the license period.

Governments may defer revenue recognition and trace revenues to the period in which the activity for the fee is charged. For instance, the fees may be used to cover the costs of regulating an activity, such as the practice of a profession. The governments might set up a special revenue fund in which it defers the recognition of revenue from license fees and allocates the deferred revenue within that fund over the service period.

Donations

Revenues from donations of financial resources are recognized when the governmental entity has an enforceable claim to the financial resources and it is probable they will be received. The financial resources need not have been actually received to recognize a donation.

Donations Defined. Donations are voluntary contributions of resources to a government by a nongovernment. Pledges for future transfers of resources and voluntary contributions between governmental entities are not covered by recognition rules for donations.

Measurement of Donations. Revenue should be recognized at the fair value of donation.

Donation of Capital Assets. To report revenue from donations of capital assets in the operating statements of governmental funds, there must be an intent to sell as evidenced either by the actual sale or the signing of a contract to sell occurring prior to the release of the financial statements. Sales price is to be used to measure the value of the donation of the capital asset. If the intent is not met, the donated assets should be reported directly in the accounts of the general fixed asset group (GFAAG) using estimated fair value of assets donated.

Nonexchange Revenues Collected or Administered by Another Government

If the reporting government is unable to obtain the required accrual information from the administering or collecting government, the actual cash received can be used for revenue recognition purposes. Cash received after the period can also be recognized when reliable information is available to enable the reporting government to attribute cash received after the period to the current fiscal year. Unlike tax revenues, there is typically no standardized lag in the receipt of cash from nonexchange revenues.

Specific Guidance for Recognition of Exchange Revenue

Exchange transactions include charges for services, investments, and operating leases. Exchange revenue should be recognized when earned, which is when the government has performed its required services. Receipt of cash is not required for revenue recognition.

Charges for Goods and Services

User fees are charges for goods and services. Revenue should be recognized when earned. This rule applies regardless of whether these fees and activities are reported through proprietary funds where there is a matching of fees earned with cost of services or whether the fees are recorded in governmental funds. Some user fees are earned when collected (e.g. the enforceable legal claim for the one-day use of golf and swimming facilities is point of collection). Some user fees are collected in advance of providing the service (monthly garbage fee or season golf permit received in advance) and should be deferred until the service is rendered. Some user fees are charged after the service is rendered; the government should recognize fee revenue and a receivable as the service is rendered (e.g., snow removal, charges billed on account).

Investment Gains, Losses, and Income

Gains and losses on investments are recognized when the investments are sold. Interest and dividend income is recognized in the period earned. Equity securities are measured and reported at cost and debt securities at cost or amortized cost. An estimated loss is to be recognized in the results of operations with a corresponding reduction in the carrying amount of the investment for declines in market value below carrying amount that are probable of being realized in the future. The new basis is the reduced carrying amount of the investment. Recoveries in value of the investment are not recognized until the investment is sold.

Mutual Funds. Investments in mutual funds are measured and reported at redemption value. Each period the changes in the mutual account balance (except for deposits and withdrawals) are reported as investment income.

Other Than Cost Specifications in Pool Agreements. If a pool agreement under which a state government is managing a local government's investments calls for a generally accepted market valuation different from cost (i.e., such as carrying an investment pool at market), those investments should be valued by both the managing entity and participating local unit using the basis specified in the agreement.

Transfers of Investment Income Between Funds

If legal or contractual provisions require the transfer of earnings on an investment between funds, the earnings are recognized in the fund reporting the investment and an operating transfer is made to the recipient fund. For instance, gains, losses, and income would be recognized in a nonexpendable trust fund and transferred to the expendable trust fund. But if state law specifically requires gains, losses, and income to become assets of the recipient fund, they are directly recognized in the recipient fund. For instance, when state law requires gains, losses, and income to accrue in the general fund, the gains, losses, and income are recognized directly in the general fund and the policy is disclosed. If gains, losses, and income become assets of the recipient funds for other reasons than legal or contractual, the fund reporting the investment picks-up gains, losses, and income and the recipient fund reports an operating transfer-in as a source of financing (not as a revenue).

Operating Leases

If the operating lease agreement calls for level payments, revenue should be recognized as it accrues over the lease term. If there are scheduled rent increases, guidance in GASB Statement No. 13, *Accounting for Operating Leases with Scheduled Increases* should be applied.

Other Financing Sources

Financial resources obtained from issuing general long-term capital debt, sale, or capital lease of long term assets and interfund operating transfers are reported in governmental funds as other financing sources.

Capital Leases and Sales of Capital Assets

A separate financial statement caption should be employed for capital assets held for capital lease or sale and reported in GFAAG. The other financing source from a capital lease is recognized at inception of a capital lease, regardless of when the amounts are received. Only when the asset is sold should the other financing source from capital asset sales be recognized.

Long-Term Note for Sale of Capital Asset

When a capital asset is sold in exchange for a long-term note, the other financing source should be recorded at fair value of the asset or at market value of the note, whichever is more determinable. If the stated interest rate is fair and adequate, the fair value of the note equals the face amount. In circumstances where there is no stated rate, an unreasonable interest rate or a material difference between face amount and cash sales price, we look to an exchange price for the asset, market value of the note, or present value of the note discounting future payments at the imputed interest rate. The difference between the other financing source (at fair value) and the face amount of the receivable as recorded in the same government fund reporting the other financing source is a discount or premium. The receivable may also be reported in the fund's balance sheet net of any unamortized discount. Interest income is to be picked up using the effective interest rate method. Principal payments reduce notes receivable with no impact on operations.

Other Than business-Like, Arm's Length Transactions

A sale by a government to another government at prices substantially below market value is not covered by measurement criteria cited as arm's length exchange transactions.

Residual Transfers

Financial resources from residual equity transfers (i.e., nonroutine or nonrecurring transfers of equity between funds) are treated as additions to beginning fund balance.

Expenditures

Governmental fund expenditures include operating, capital, and debt service expenditures. Ordinarily, expenditures are recognized when transactions or events take place that result in claims against financial resources, such as when a liability is incurred. No cash collection is required.

Expenditures in governmental funds are decreases in financial resources from transactions other than interfund transfers, issuance discounts on general long-term capital debt, and refundings of general long-term capital debt.

Specific Guidance for Operating, Capital, and Debt Service Expenditures

Recognition of Operating Expenditures

Operating expenditures result from either exchange or nonexchange transactions. Those arising in exchange transactions should be recognized when the transaction resulting in claims against financial resources take place. Cash need not be disbursed to recognize an operating expenditure. For example, expenditures for wages are recognized when the work is performed.

Nonexchange Operating Expenditures. Recognition for nonexchange operating transactions and events is being dealt with in a separate project. For instance, nonexchange transactions include government transfers of resources for legislatively approved entitlement and grant programs such as education, housing, and food.

Departure from Previous Practices. Accrual of operating expenditures is a departure from previous practices under which governments do not recognize expenditures if the liabilities will not be paid with currently available financial resources.

Prepaid Items

Prepaid items are payments in advance of receipt of goods and services in an exchange transaction (e.g., rent and insurance). The consumption method is to be used as a recognition method for prepaid items. Under the consumption method, the acquisition of prepaid items is to be reported as financial resources when related services are received, and an expenditure is to be recognized.

Supplies Inventory

Expenditures for supplies inventory are to be recognized under the consumption method. Supplies inventory is to be reported as financial resources when acquired and as an expenditure when the items are used. This is a change from present practice, which allows the ption of the consumption method or recognition of an expenditure when the supplies are purchased.

Valuation of Inventory

Existing GAAP applies for valuation of inventory.

Compensated Absences

Compensated absences include vacation, sabbaticals, and holidays. Compensated absences, except for sick leaves, are recognized by governmental units when the following conditions exist:

- The employee's rights to receive compensation for future absences are attributable to services already rendered
- The rights are accumulating and vesting
- Payment of compensation is probable
- The amount can be estimated

If the amount cannot be estimated, the governmental unit shall disclose that expenditures for compensated absences are not recognized.

Accumulating and Vesting of Benefits. Accumulated benefits are those earned unused rights to compensated absences that may be carried forward into future, even though limits may be set as to the amounts. Vesting are rights an employer has an obligation to pay, even upon termination of the employee. Vesting includes rights that will vest even though they have not yet vested. Since governments often limit the vesting rate or number of days, most sick leave tends to be nonvesting or partially vesting.

Recognition of Earned Sick Leave. Expenditures for earned sick leave should be accrued only if the benefits are vested, for instance, if any employee is entitled to the benefits if employment is terminated. Vesting benefits are recognized when—

- The rights to receive compensation are for services already rendered.
- Payment of the compensation as a termination benefit is probable.
- Amounts can be reasonably estimated.

When earned sick leave is not recognized because the amount cannot be estimated, that fact is to be disclosed in the financial statements.

Compensation for Nonvesting Sick Leave. Expenditures for nonvesting sick leave should not be accrued as earned; rather, they should be recognized when taken.

Sabbaticals. Compensation for sabbaticals for research, public service, or training should not be recognized prior to the leave, since service is not yet rendered. If sabbatical is granted for past service without restrictions, recognition of expenditures for leaves is recognized when earned.

Paid Absences Not Attributable to Illness. If employees are paid by the government unit for sick leave benefits even though absences are not attributable to actual illness, these benefits should not be considered sick leave benefits. They are to be accounted for under guidance for compensated expenditures.

Operating Leases

Expenditures for operating leases requiring level expenditures are recognized as they accrue over the lease term and are based on terms of the agreement. GASB Statement No. 13 gives guidance for accounting for leases with scheduled rent increases.

Capital Expenditures

Capital expenditures are recognized when the asset is acquired regardless of when cash is paid. This requirement is consistent with previous practice and standards.

A capital asset is to be measured at its fair value, when the asset is acquired through a long-term installment purchase in an arm's length transaction.

Residual Equity Transfers

Residual equity interfund transfers are nonrecurring or nonroutine transfers of equity between funds. Claims against resources from residual equity transfers are reported on the operating statement as deductions from beginning fund balance.

Other Financing Uses

In the operating statement, claims against resources resulting from refunding of general long-term capital debt, issuance discounts on long-term capital debt, and operating interfund transfers out are reported as other financing uses. Operating interfund transfers include all transfers that are not residual equity transfers.

Debt

GASB Statement No. 11 distinguishes between long-term capital debt and operating debt. The Statement provides operating statement recognition rules for the repayment of operating debt and balance sheet reporting guidance for capital assets. Other GASB projects will deal with presentation of liabilities from governmental fund operating expenditures and operating statement guidance for the effect of payment of capital debt.

Capital Debt

Capital debt is long-term debt used to acquire capital assets or to finance nonrecurring projects or activities with long term economic benefit. Capital debt includes debt issued by the government entity for its own purposes as well as to provide capital grants to other government entities. Capital debt includes liabilities from long-term vendor financing, such as capital leases and installment purchases.

BANs. Short-term debt such as bond anticipation notes can be included in general long-term capital debt if expected to be replaced by other debt and the debt issues are expected to be outstanding for a period exceeding one year.

Reporting Capital Debt. At issuance, general long term capital debt is reported in the government fund receiving the cash as an other financing source. Bond issue costs paid from bond proceeds are expenditures (e.g., underwriting fees). The premium or discount, which is the difference between face amount and cash received on the issuance, is an other financing source or use. Other out-of-pocket costs attributable to the financing are expenditures when incurred (e.g., rating agency fees). The face amount of general long-term debt is to be reported at issuance as a liability in the general long-term debt account group (GLTDAG). The face amount of the debt in the GLTDAG will equal and be balanced by (1) the amount available in debt service funds for debt principal payments and (2) the amount to be provided in future periods, as shown in the GLTDAG.

Reporting Long-Term Vendor Financing. At date of acquisition, an installment purchase of a capital asset is reported as a capital expenditure and as an other financing source. In an exchange that is an arm's length transaction, if the note's stated rate is not fair and adequate, the capital asset is recorded at fair value of the asset or market value of note, whichever is more determinable. Additionally, an other financing source is reported face value in the government fund recording the expenditure for the capital asset. Any discount or premium on the installment purchase is an other financing source or use in the operating statement. The installment liability is also reported in the GLTDAG.

Retroactive Borrowings. General long-term capital debt includes retroactive borrowing if either of the following conditions exists:

- The intent at acquisition of the capital asset is to finance the capital assets on a long-term basis.
- That financing is obtained within one year after the capital asset is acquired.

A bond referendum providing approval of long-term financing of the capital project or capital financing plan could be used to demonstrate intent to acquire through long-term financing.

Short-Term Vendor Financing. Accounts payable and other short-term capital asset acquisitions payable in one year or less are government fund liabilities.

Treatment of Discount or Premium. Under GASB Statement No. 11 discount or premium on long-term capital debit is not being amortized over time using the effective interest rate method.

Treatment of Bond Issue Costs. Under GASB Statement No. 11 bond issues costs are not deferred and amortized over time; rather they are treated as expenditures in the operating statement.

Debt Extinguishment and Defeasance of Capital Debt. When new debt is issued to extinguish or defease debt, the receipt is reported at face amount as an other financing source in the operating statement of the governmental fund.

The amount refunded coming from new debt financing is reported as an other financing use in the same fund reporting the source of funds. Captions such as "Refunding Bonds Issued" and "Payment to Refunded Bond Escrow Agent" can be employed. Payments to retire or defease debt coming from sources other than new debt are reported as debt service expenditures. The GLTDAG is adjusted for changes in long-term debt from the refunding.

Long-Term Operating Debt

Operating debt is debt that provides financial resources to and is expected to be repaid from financial resources of governmental funds and does not meet requirements to be designated as capital debt. The GASB does not believe interperiod equity is reported by treating borrowings for operations as an inflow of financial resources.

Reporting for Operating Debt. Operating debt is reported in the balance sheet of the related governmental fund, not in the GLTDAG. There is no recognition as another financing source for the face amount of the operating debt, nor are discounts or premiums on issuance treated as an other financing source or use. Payments of debt principal are not reported in the operating statements as expenditures for principal.

Underwriters' Fees. Underwriters' fees and other issue costs paid out of the proceeds of the debt are treated as expenditures.

Out-of-Pocket Costs. Out-of-pocket costs are treated as expenditures when the liability is incurred.

Interest. Interest is recognized over time using the debt's effective interest rate.

Long-Term Vendor Financing Using Operating Debt. If interest rates on the debt are fair and adequate, the face amount of the note can be used to measure the expenditure for goods and services. The guidance for operating debt is to be used. If interest rates are not fair and adequate, the fair value of the goods and services or the market value of the debt, whichever of the two is more determinable, is used to measure the expenditure or financial resource.

Expendable Trust Funds

A flow-of-resource focus is to be used for expendable trust fund operating statements.

DISCLOSURE OF INFORMATION ON POSTEMPLOYMENT BENEFITS OTHER THAN PENSION BENEFITS BY STATE AND LOCAL GOVERNMENTAL EMPLOYERS— GASB STATEMENT NO. 12

Introduction

The pronouncement establishes standards for disclosure of information on postemployment benefits other than pension benefits (OPEB) by state and local governments. SFAS 81 is no longer applicable. Postemployment is considered to include not only the period after the formal retirement date, but also the period after termination but before retirement. Disclosure requirements are not altered by the fund type used to account for OPEB transactions. Except for additional disclosures, there are no changes in accounting and reporting for OPEBs.

Scope

GASB Statement No. 12 disclosure requirements do not apply to pension benefits nor to special termination benefits. These areas are covered in sections P20, "Pension Activities—Employer Accounting," and T25, "Termination Benefits (Special)" of the *Codification of Governmental Accounting and Financial Reporting*. Also excluded from GASB Statement No. 12 are those other pension-related benefits with the exception of postemployment health care provided by a state or local governmental unit to its plan participants or beneficiaries through its public employee retirement system (PERS), pension plan, or other retirement income arrangements. GASB Statement No. 12 disclosures are applicable even if the governmental unit provides for assets to cover costs on an actuarially determined basis or employs other forms, means, or timing for covering costs.

Applicability

All government employers who bear all or a portion of OPEB costs are subject to GASB Statement No. 12. This includes public benefit corporations, public employee retirement systems, government utilities, hospitals, colleges, and universities. Reporting requirements hold regardless of fund type used to handle OPEB transactions.

Definition and Examples of OPEBs

While postemployment health care is always an OPEB, the method of rendering the benefits determines type of classification for other benefits. Other benefits rendered through a public employee retirement system, pension plan, or other retirement arrangement are not OPEBs.

An example of an OPEB is disability income provided through a separate plan covering plan participants, beneficiaries, and covered dependents. However, disability income provided as part of the pension plan is excluded. Other examples of OPEBS are postemployment health care benefits, life insurance, disability income, tuition assistance, and legal services provided, but they must be provided in separate plans apart from those providing retirement income. In applying GASB Statement No. 12, a determination must be made whether a benefit is to be categorized as a pension benefits or OPEBs.

Effective Date

GASB Statement No. 12 is effective for fiscal years beginning after June 15, 1990, with earlier application encouraged.

Required Disclosures

Disclosures can be made separately for each type of OPEB or in the aggregate. Disclosures should be made for the reporting entity as a whole. Additional disclosures can be made by fund type. The minimum disclosures are described in Exhibit 4-3.

Employers may substitute required disclosures under Codification Section P20e "Pension Activities—Employer Reporting." Employers electing this option should disclose their assumption as to rate of health care inflation and must calculate funding status and funding status in progress using a standardized measure consistent with that required by the pension pronouncement. Employers are encouraged but not required to provide separate disclosure of funded status and funding progress for post employment health care benefits, since it may be impractical to subdivide amounts of actuarially required contributions, plan assets, obligations, and unfunded obligations. A calculation of funding status and progress of post employment health care benefits is to be made.

Exhibit 4-3 ***Minimum Required OPEB Disclosures***

A. Description of OPEB Provided including—

- Employee groups covered
- Eligibility requirements
- Quantification of obligation borne by employer and participants

B. Identification of statutory, contractual, or other authority establishing OPEB provisions and required contributions by employer

C. Statement describing accounting and funding policies

D. Expenditure/expense information—

- For OPEBs funded on a pay-as-you-go basis, provide the expenditures/expense recognized during the period (net of participant contributions) and number of eligible participants. Reasonable estimates can be made where OPEB expenditures/expenses cannot be disaggregated from other benefit expenditures/expenses. Situations where an estimate cannot be made are to be disclosed.
- For OPEBs advance-funded on an actuarially determined basis, provide the number of active plan participants and the

Exhibit 4-3 *(cont.)*

actuarially required and actual contribution for the period (net of participant contributions), the net assets available for OPEB, and the actuarially accrued liability and the unfunded actuarially accrued liability under the cost method employed by the actuary.

E. Description and, where possible, dollar amount of impact of occurrences affecting comparability with earlier periods, such as changes in actuarial assumptions

F. Other significant information enabling user to understand extent and nature of OPEB costs

ACCOUNTING FOR OPERATING LEASES WITH SCHEDULED RENT INCREASES—GASB STATEMENT NO. 13

Introduction

GASB Statement No. 13 establishes standards for accounting and reporting by state and local governments for operating leases with scheduled rent increases. A scheduled rent increase is defined as one fixed by contract. Scheduled rent increases occur with the passage of time and may have terms based on expected increases in cost or in value of a property. The amounts of the increases are contained within the lease and are not contingent on future events. Scheduled increases differ from contingent rentals, the latter being tied to changes occurring after the inception of the lease in factors on which lease payments are based (e.g., rates of changes in a price index).

Current Practice. Governmental entities currently account for rental revenues and expenses from operating leases with scheduled rent increases on a level basis over the lease term (GASB Codification Section L20), which is identical to guidance as required in SFAS No. 13 and FASB TB 85-3. Current practice rules provide for an exception to straight-line amortization under situations where increasing rentals are tied to use of property. In the case of escalating payments tied to use, another systematic and rational basis may better reflect the time pattern in which the benefits are derived from the leased property. Accordingly, an allocation technique other than straight-line may be appropriate.

Accounting for Operating Leases with Scheduled Rent Increases

Applicability

The new GASB Statement No. 13 requirements are applicable to all operating leases with scheduled rent increases. All state and local governmental bodies including public benefit corporations, public employee retirement systems, and governmental utilities, hospitals, colleges, and universities must follow this pronouncement. All fund types are subject to the standard.

Measurement Rules

When the pattern of lease payment is systematic and rational, the statement requires that operating leases with scheduled rent increases be accounted for employing the lease contract terms. Examples of situations under which the lease terms are considered systematic and rational include: (a) lease terms with scheduled increases in rent taking into account economic factors related to the impact of appreciation in property value or cost increases from inflation and maintenance; (b) lease payments based on the time pattern in which the leased property is available for use of the lessee.

Operating Leases with Artifically Low Rental Payments

When an operating lease with scheduled rent increases requires lease payments that are artificially low in certain periods, the accounting for the lease transactions should be based either on a straight-line basis or on estimated fair value of the rental. Where the fair value of the rental is not reasonably measurable, a straight-line basis is to be used. When the fair value method is employed, the lessor's financing of the lessee's cash flow is to be accounted for using the effective interest rate method, so that a constant rate of interest is accrued on the outstanding lease receivable or payable.

Examples of artificially low rental payments are offers of rent holidays to lessees as a form of financing arrangement and offers of reduced rents to induce lease signing.

Recognition Rules

Governmental bodies are to accrue each period rental revenues and rental expenditures/expenses following the measurement guidelines specified in this pronouncement. In situations where the fair value method is employed, interest revenue or interest expenditure/expense is recognized using the effective interest method.

Cases Analyzing Measurement Rules

Case 1: Calculation of operating lease expense/expenditure

An enterprise fund for a hospital has signed a five-year lease agreement requiring an initial payment of $50,000 and annual increases of 5 percent to cover the anticipated effects of inflation.

In this case, we show the amount and the time period that the rental expense is recognized. We then consider a modification of the case when the operating lease makes provisions for a payment of only $5,000 in rent in the first year.

Lease payments are recognized each year in the same pattern as required in the contract. The amounts recognized each period are shown in Exhibit 4-4.

Exhibit 4-4 *Lease Expenditures Recognized*

Year	*Equal Payments Made*
1	$50,000
2	52,250
3	55,125
4	57,881
5	60,775

If the contractual lease payment in year 1 is only $5,000, the accountant would have to determine whether the initial reduction is attributable to economic factors related to the property. Perhaps there are some limitations in availability of the entire facility for its initial intended use. In such a case, the lease transaction should still be measured based on the contractual rental payments. On the other hand, if the initial rent is artificially low because the lessee has some immediate cash flow difficulties, the later scheduled rent increases are really compensation for not receiving fair rental in earlier lease periods. Thus, part of the later payments are really payments of rent and interest relating to year 1. Similarly, the lower rental payment may simply be an inducement to lease the space and again the accounting should not be based on contract terms but rather on straight-line or fair value methods.

Case 2: Basing measurement on fair value method

An airport authority enters into a five-year lease with Fly-by-Knight Carrier (FBK) requiring $100,000 annual payments. The same authority enters into a second five-year lease with Stump Carrier for a similar space. However, the payments to be made under the Stump lease are $25,000 in the first year, $100,000 for the next three years, and $209,944 in the last year of the lease. The reason for this is to relieve Stump Carrier of cash flow difficulties.

Since the operating leases are for similar space, but with widely varying payment terms, the objective of this case is to demonstrate the application of the fair value method. Lease rental revenue on Stump's lease is determined based on the lease with Fly-by-Knight carrier. A 10-percent interest rate equals the two payment streams. (See Exhibit 4-5.) Since Stump's rental payment in the first year is artificially low, later payments include some prior-year financing costs. The fair value of the lease with FBK will be used to establish the pattern of yearly rent recognized on the lease with Stump. Revenue recognized in each year consists of the $100,000 in accrued rent plus 10-percent interest on receivables. From Exhibit 4-5, we can see that lease revenue recognized by the authority is $107,500 in the first year and $108,250 in the second year.

Effective Date

Proprietary and similar trust funds shall adopt the provisions for all leases with terms beginning after June 30, 1990.

For governmental and similar trust funds, the measurement

Exhibit 4-5

Year	*Cash Payment Stump*	*Accrued Rent Stump*	*Interest Revenue Stump*	*End of Year Receivable*
1	$ 25,000	$100,000	$7,500	$ 82,500
2	100,000	100,000	8,250	90,750
3	100,000	100,000	9,075	99,825
4	100,000	100,000	9,983	109,808
5	209,808	100,000	0	0

rules are effective for all leases with terms commencing after June 30, 1990. Recognition rules for governmental and similar trust funds are effective following the adoption of GASB Statement No. 11, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements*, for periods beginning after June 15, 1994. Until the adoption of GASB Statement No. 11, revenues/expenditures shall be recognized each period using a modified accrual basis of accounting. Accordingly, lease revenue is to be recognized by the lessor only to the extent it is available to finance expenditures of the fiscal period. Expenditures and fund liabilities are to be recognized by the lessee only to the extent amounts are payable with expendable, available resources. Amounts accrued under the GASB Statement No. 13 measurement rules for accounting for lessor rental income shall be presented in the governmental and similar trust fund with a deferred amount set up to offset the portion not yet recognized under existing recognition rules. Remaining accrued liabilities under GASB Statement No. 13 provisions in excess of amounts recognized as expenditures and fund liabilities shall be reported in the general long-term debt account group (GLTDAG). In addition, the operating statement or notes to those financial statements shall report the total amounts calculated under measurement rules in the pronouncement adjusted for the changes in GLTDAG liability. For example:

Expenditures:

Operating leases ($30,000, which is the total amount determined for the year under GASB Statement No. 13, less $10,000 increase in GLTDAG liability) $20,000

Impact on Existing Operating Leases. Retroactive restatement of leases with terms commencing before July 1, 1990 is permitted. When the entity elects retroactive application, prior period financial statements should be restated with the cumulative effect of applying GASB Statement No. 13 reported as a restatement of beginning fund balance or retained earnings, as appropriate, for the earliest period restated. Upon adoption of GASB Statement No. 13, disclosure is to be made of the nature and effects of any restatements.

CHAPTER 5
FASB Exposure Draft

CHAPTER 5
FASB Exposure Draft

EMPLOYERS' ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

In February 1989, the Financial Accounting Standards Board (FASB) issued an exposure draft of a proposed Statement, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* which could have a significant impact on the financial statements of companies that have such plans. The proposed Statement would require a change in accounting for such benefits from the pay-as-you-go method of accounting, which currently is predominant practice, to an accrual basis.

Would Apply Principles of SFASs 87 and 88

The proposed Statement would establish standards of financial accounting and reporting for an employer that offers postretirement benefits other than pensions (postretirement benefits) to its employees.

Currently, most employers account for postretirement benefits on a pay-as-you-go basis. The proposed Statement would require the use of accrual accounting principles as promulgated in FASB Statement No. (SFAS) 87, *Employers' Accounting for Pensions,* and SFAS 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits.* To the extent that the promise of postretirement benefits is similar to the promise to provide pension benefits, the provisions in the proposed Statement would be the same or similar to those prescribed by SFASs 87 and 88.

The FASB essentially views a postretirement plan as a deferred compensation arrangement. Consequently, the proposed Statement would require employers to—

- Recognize net periodic postretirement benefit cost as employees render the services.

- Apply a uniform method for similar plans to measure the accumulated postretirement benefit obligation and the related cost of postretirement benefits.

Different accounting treatment would be prescribed only when there are compelling reasons for different treatment.

In applying accrual accounting to postretirement benefits, the proposed Statement would adopt the three fundamental aspects of pension accounting:

1. Delayed recognition of certain events:
   - Changes in the obligation arising from plan initiation or amendment
   - Certain changes in the value of plan assets
2. Reporting net cost:
   - Service cost
   - Return on plan assets
3. Offsetting:
   - Plan assets would be offset against the accumulated postretirement obligations.
   - Return on plan assets would offset postretirement benefit costs.

In addition, the porposed Statement would call for the disclosure of certain unrecognized items as is required by SFAS 87.

Applicable to All Postretirement Benefits

The proposed Statement applies to all postretirement benefit plans. A postretirement benefit plan is defined as "an arrangement whereby an employer undertakes to provide its employees with benefits during their retirement in exchange for their services over a specified period of time, upon attaining a specified age while in service, or both. Benefits may commence immediately upon termination of service or may be deferred for payment upon attaining a specified age."

Postretirement benefits may include health care, life insurance outside a pension plan, and other welfare benefits such as tuition assistance, day care, legal services, and housing subsidies provided after retirement.

Health Care. The proposed Statement focuses principally on postretirement health care benefits, which in fact make up the overwhelming portion of such costs.

Settlements and Curtailments. The proposed Statement also applies to the following:

- Settlements of all or part of a plan
- Curtailment of a plan
- Benefits provided as part of a special termination benefit offer

Defined Benefits. The proposed Statement primarily focuses on an employer's accounting for a single-employer plan. A defined benefit postretirement plan is one that defines the postretirement benefits in terms of either of the following:

- Monetary amounts ($100,000 of life insurance)
- Benefit coverage (up to $200 a day for hospitalization; 80 percent of cost of specified procedures)

Full Eligibility. A plan may define full eligibility for postretirement benefits in terms of compensation levels, years of service, attained age while in service, or a combination of these factors.

Benefit Formula. The amount of the benefits depends on the benefit formula, which includes the eligibility factors, how long the retiree and any beneficiaries and covered dependents live, and the incidence of events requiring benefit payments.

Not Applicable to Certain Plans

The proposed Statement does not apply to the following:

- Benefits to selected employees under individual contracts with specific terms determined on an individual-by-individual basis
- Benefits provided currently to active employees
- Pension or life insurance benefits provided through a pension plan
- Temporary benefits provided only to certain employees after their employment, but not provided to employees who retire

Basic Elements of Accounting

The basic elements of accounting for postretirement benefits are discussed below.

Expected Postretirement Benefit Obligation

For an employee this is the actuarial present value, as of a date, of the postretirement benefits expected to be paid to the employee, the employee's beneficiaries, and any covered dependents pursuant to the plan. Future compensation levels would be relevant if benefits are based on future compensation (pay-related plans).

Accumulated Postretirement Benefit Obligation

This is the actuarial present value, as of a date, of all future benefits *attributed* to employee service rendered to that date. This computation requires that increases in benefits be attributed to years of service as provided by the plan and subject to the provisions of the proposed Statement to be discussed later. Prior to full eligibility, the accumulated postretirement benefit for an employee is a portion of the expected obligation. On and after full eligibility, the two amounts are the same.

Given the delayed-recognition approach to accounting for experience gains and losses and other effects, the net periodic postretirement benefit cost is not tied to the change in the unfunded accumulated postretirement benefit obligation for the period, exclusive of employer contributions to the plan, plan settlements, and payments made directly to retirees.

Net Periodic Postretirement Benefit Cost

This consists of the following components:

Service Cost. The actuarial present value of the expected postretirement benefit obligation attributed to employee service during the reporting period is service cost.

Interest Cost. The increase in the accumulated postretirement benefit obligation to recognize the effects of the passage of time is interest cost.

Actual Return on Plan Assets. The actual return on plan assets would be determined on the basis of the fair value of plan assets at the beginning and end of the period adjusted for contributions and benefit payments.

Amortization of Prior Service Cost. In the absence of plan provisions defining the specific period of service to which the plan amendment applies, plan amendments would be viewed as retroactive. The prior service cost would be amortized by assigning an equal amount to each remaining year of service to full eligibility for benefits of each plan participant active at the date of the amendment. To reduce complexity a straight-line amortization of the cost over the average remaining years of service to full eligibility for benefits of the active plan participation would be acceptable. A plan amendment that reduces the accumulated postretirement benefits obligation would be used first to reduce any existing unrecognized prior service cost, then any remaining transition obligation.

Amortization of Transition Obligation or Asset. As of the beginning of the fiscal year in which the proposed Statement would be first applied (the transition date), the accumulated postretirement benefit obligation and the fair value of plan assets plus any recognized accrued postretirement benefit cost less any recognized prepaid benefit cost would be determined. The unrecognized transition obligation or asset could be recognized immediately on initially implementing the standard, in some circumstances. In most cases, however, the transition asset or obligation would be amortized on a straight-line basis over the average remaining service period of active plan participants. If that average is less than 20 years, the employer may elect to use a 20-year period. The Board has tentatively concluded that the effect of transition should be reported as a change in accounting principle if recognized immediately or as a component of net periodic postretirement benefit cost if recognized on a delayed basis.

The proposed Statement would provide for a more rapid amortization under certain circumstances that involve a comparison of cumulative accrual basis and cash basis amounts.

Gain or Loss Component–Deferred and Amortized. This component includes the difference between the actual return on plan assets and the expected return on plan assets for the current year (defers the difference between the actual return and the expected return) and amortization of unrecognized net gain or loss from previous years.

Gains or losses would arise if experience differs from that assumed for return on plan assets or from the assumed accumulation of the postretirement benefit obligation or from changes in assumptions. Although gains and losses can be recognized immediately, the proposed Statement would not require the recognition of gains or losses in the period that they arise. Rather, an unrecognized net gain or loss would be included as a component of net postretirement benefit cost for a year if, as of the beginning of the year, that unrecognized net gain or loss exceeded 10 percent of the greater of the accumulated postretirement benefit obligation or the market-related value of plan assets. If required, the minimum amortization would be the excess divided by the average remaining service period of active plan participants. Exceptions are provided for other systematic methods and immediate recognition.

Implementation Issues. In other meetings, the FASB considered implementation issues in measuring an employer's postretirement benefit obligation and tentatively concluded that:

- The cost of administering a plan should be included in developing the per-capita cost of benefit coverage that is projected to determine an employer's postretirement benefit obligation.
- If an employer "forgives" a retrospective adjustment of the current or past years' cost-sharing provisions as those provisions relate to benefit payments already made, the effect of the forgiveness should be immediately recognized as a loss.
- If an employer deviates from the substantive plan on a one-time basis to increase or decrease benefit payments relating to current or past periods, the effect of that temporary deviation from the substantive plan should be immediately recognized as a gain or loss.

Measurement of Cost and Obligation

The proposed Statement would require the use of explicit assumptions in the process of measuring the expected postretirement benefit obligation. Each assumption would have to represent the best estimate of a particular future event. A portion of that expected benefit would then be attributed to each period as service cost.

The accumulated postretirement benefit obligation would be the aggregation of the expected postretirement benefit obligation *attributed* to plan participants' prior service periods associated with earning the postretirement benefits together with interest thereon, less benefit paid.

Principal Actuarial Assumptions

- *Discount rate*—reflects the current rate of return on high-quality, fixed-income investments. The same rate would be used in determining the interest cost component of net periodic postretirement benefit cost.
- *Amount and timing of future benefit payments*—would consider past and present per-capita claims cost by age, health care cost trend rates, medical reimbursement rates (Medicare), salary progressions (for pay-related plans), and probability of payment (turnover, retirement, dependency status, mortality, and the like). In certain situations, changes in retiree cost-sharing provisions could be anticipated.
- *Expected long-term rate of return on plan assets*—would reflect the average rate of earnings expected on the existing assets that qualify as plan assets. The expected rate of return on plan assets would be applied to the market-related value of plan assets to compute the expected return on plan assets. Most existing plans are unfunded and thus would not have to deal with this element.

Assumptions Unique to Health Care Benefits

The assumption that is unique to postretirement health care benefit measurement is the assumed per-capita claims cost by age, which is the future per-capita cost, after the measurement date, of providing the postretirement health care benefits at each age from the earliest ages at which plan participants could begin to receive benefits through their remaining life expectancy. Measurement requires consideration of many assumptions, critical among which are health care cost trend rates, Medicare reimbursement rates, and health care utilization or delivery patterns and medical technology.

Attribution Methods

Except for plans with benefit formulas that attribute benefits in a disproportionate way to later years, the expected postretirement benefit obligation for a plan participant would be attributed to periods of employee service to the full eligibility date, based on the plan's benefit formula, if the formula states how the obligation should be attributed.

If the plan's benefit formula does not specify the benefits earned for a specific period of service, an equal amount of the expected postretirement benefit obligation would be attributed to each year of service in the attribution period (a benefit/years-of-service approach).

The beginning of the attribution period would be the date of hire, unless the plan's formula grants credit only for service from a later date, in which case benefits would be attributed from the beginning of that credited service period.

Minimum Liability Not Required

The Board decided to drop the requirement to recognize a minimum liability.

Plan Assets

The accounting for plan assets would follow SFAS 87 principles. At present few plans are funded.

Disclosure

The disclosures would follow the requirements of SFASs 87 and 88. The board has tentatively concluded that the effects of a one-percentage-point increase in the assumed health care cost trend rate on measurement of the accumulated postretirement benefit obligation and on the combined service and interest cost components of net periodic postretirement benefit cost should be disclosed. This is a modification of the sensitivity disclosure proposed in the Exposure Draft. The disclosure of the vested postretirement benefit obligation would not be required.

The FASB recently discussed the extent to which disclosures for different postretirement benefit plans of the same company may be combined. The FASB tentatively concluded that—

- Employers should be permitted to combine disclosures for plans that provide primary postretirement health care benefits with those for other postretirement benefits, unless postretirement benefits other than health care are significant in relation to the accumulated postretirement benefit obligation.

- Employers should be permitted to aggregate overfunded and underfunded plans for disclosure purposes.
- Separate disclosure of the accumulated postretirement benefit obligation and plan assets of each underfunded plan would be required.

Other Matters Covered

The proposed Statement also covers the following:

- Employers with more than one plan
- Insurance contracts
- Multiemployers plans
- Multiple-employer plans
- Non-U.S. plans
- Business combinations
- Accounting for settlements, curtailments, and termination benefits
- Disposal of a segment
- Defined contribution plans

As in the case of accounting for single-employer postretirement benefit plans, the proposed Statement continues to track SFASs 87 and 88 in other areas. For example, in the case of business combinations, the proposed Statement would require that the assignment of the purchase price to individual assets acquired and liabilities assumed should include a liability for the accumulated postretirement benefit obligation in excess of the fair value of plan assets or an asset for the fair value of plan assets in excess of the accumulated postretirement benefit obligation. If it is expected that the plan will be terminated or curtailed, the effects of those actions should be included in the allocation process. As a result of this procedure, any unrecognized items would be eliminated for the acquired employer's plan.

Recently, the Board considered measurement of the postretirement benefit obligation assumed in a business combination accounted for as a purchase. The FASB tentatively concluded that—

- The obligation assumed by the acquiror should be measured based on the substantive plan (which could differ from the amount measured by the seller if the acquiror satisfies the conditions for accounting for a substantive plan that differs from the written plan).
- Improvements to the seller's plan that apply to employee service rendered prior to the date of the combination and that are conditions of the purchase agreement should be accounted for in connection with the purchase accounting.
- Other plan changes should be accounted for as prior service cost.

These conclusions modify the view expressed in the Exposure Draft to achieve consistency with the FASB's previous tentative conclusion to permit anticipation of changes in the cost-sharing provisions of a plan for measurement purposes if certain conditions are met.

Proposed Effective Dates

The proposed Statement would be effective for calendar year 1993 financial statements. However, the effective date would be two years later for (a) non-U.S. plans or (b) plans of employers that are nonpublic companies and that sponsor no plan with more than 100 plan participants.

Transition

If at the transition date an employer has excluded assets in a postretirement benefit fund from its balance sheet, and some or all of the assets do not qualify as plan assets, the employer would recognize in its balance sheet the fair value of the plan assets and an equal amount as an accrued postretirement benefit obligation.

Pronouncements to Be Superseded, Rescinded, or Amended

The proposed Statement would supersede SFAS 81, *Disclosure of Postretirement Health Care and Life Insurance Benefits,* which serves as a temporary measure to require certain disclosures.

The proposed Statement would also rescind FASB Technical Bulletin No. (TB) 87-1, *Accounting for a Change in Method of Accounting for Certain Postretirement Benefits.*

Accounting Principles Board (APB) Opinion No. 12, *Omnibus Opinion*, which deals with deferred compensation contracts, would be amended to the extent that SFAS 87 and the proposed Statement apply to deferred compensation contracts with individual employees if those contracts, taken together, are equivalent to a postretirement income or health or welfare benefit plan. For other deferred compensation contracts accounted for on an individual basis, the accrual basis is required, and if the contract does not define the specific years of service, the amount expected to be paid should be accrued in accordance with the proposed Statement from the date the contract is entered into to the date the employee attains full eligibility for the benefits.

Paragraph 88 of APB 16, *Business Combinations*, which provides general guidelines for assigning amounts to the individual assets acquired and liabilities assumed in a purchase business combination, would be amended to incorporate the reference that paragraphs 82 and 83 of the proposed Statement should be applied to assets and liabilities related to postretirement benefits.

Immediate Rescission

Effective with issuance the proposed Statement would rescind TB 87-1, *Accounting for a Change in Method of Accounting for Certain Postretirement Benefits*. If a change in method is adopted subsequent to the issuance of the proposed Statement, the new method should comply with the provisions of the Statement.

CHAPTER 6

The FASB Emerging Issues Task Force

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The FASB Emerging Issues Task Force

INTRODUCTION

In 1984, the Financial Accounting Standards Board (FASB) created the Emerging Issues Task Force (EITF) in response to a pressing need for more timely guidance on new accounting issues. The recent proliferation of innovative business transactions has triggered a number of complex accounting issues, many of which are narrow implementation issues or industry specific. However, the FASB's due process mechanism by nature limits the Board's ability to deal promptly with these issues. What's more, within the profession, there is a growing concern about a "standards overload," that is, addressing narrow issues by issuing new pronouncements.

The EITF includes representatives from both accounting firms and industry. Presently, there are nine accounting firms and four major corporations represented on the task force, which is chaired by the FASB director of research and technical activities. In addition, an SEC observer, ordinarily the chief accountant, actively participates in EITF meetings as does a representative of the AICPA accounting standards executive committee.

Through the cooperative efforts of practitioners, the FASB, and the SEC, the EITF addresses, and ultimately resolves, many of these narrow issues without formal due process procedures. In other words, the EITF shapes practice without setting standards. In Staff Accounting Bulletin No. 57, footnote 4, the SEC indicated that it will assist in identifying, and in some cases resolving, complex accounting issues. The commission stated—

> the authoritative accounting literature cannot specifically address all the novel and complex business transactions into which registrants might enter. . . . The [SEC] staff intends to participate in the activities of [the task force] and believes the group's efforts will be most effective if preparers of financial statements and/or their independent

accountants apprise the group of intended accounting for new business transactions.

While serving as SEC Chief accountant, Clarence Sampson indicated that SEC registrants will be called on to justify accounting that differs from a consensus reached by the EITF.

TASK FORCE OPERATING PROCEDURES

Approximately every six weeks, EITF members hold a meeting to discuss issues that have been placed on the agenda. For each issue, members of either the task force or the FASB staff prepare an Issues Summary Package comprising an Issues Summary Form and other attachments. While most Issues Summary Packages attempt to present a neutral discussion of the issue, they sometimes advocate accounting positions. Views contained within an Issues Summary Package represent the views of the preparer prior to the task force's discussion. Also attached to each Issues Summary Package are extracts from the minutes of each task force meeting at which the issue is discussed. An issue is summarized at the meeting by the EITF member who raised it or by a member of the FASB staff. Following the discussion, the chairman polls EITF members to ascertain whether there is a consensus on the issue. If fewer than three members object, the consensus is recorded in the minutes. In some situations, the discussion is inconclusive, and various aspects may be further discussed in subsequent meetings. Even if a consensus is not reached during a meeting, the FASB obtains insights about members' views on particular transactions; areas where guidance is required on a timely basis; areas where guidance awaits work on an existing FASB project; and areas where further guidance is not required.

NATURE OF ISSUES EXAMINED

As of July 18, 1990, the EITF has discussed 219 accounting issues, which have been categorized in Appendix A. Of these 219 issues, 85 were related either to financial institutions or to financial instruments. Detailed listings of these accounting issues by group are available.

DISPOSITION OF ISSUES

Appendix B provides the disposition of the 219 accounting issues accepted for consideration by the EITF. Of that number, 151 issues addressed by the EITF were resolved by consensus, while 24 issues were resolved by the FASB. Actions settling these issues include a number of Technical Bulletins and FASB statements. For instance, Issue 84-3, *Convertible Debt Sweeteners*, was resolved by Statement of Financial Accounting Standards (SFAS) 84, *Induced Conversions of Convertible Debt*. Issue 85-4, *Common Control Questions*, was resolved by FASB Technical Bulletin (TB) 85-5, *Issues Relating To Accounting for Business Combinations*. Twenty-four issues have not been resolved under the EITF framework.

ACCESSING AND RESEARCHING ISSUES ADDRESSED BY THE EITF

The FASB offers a subscription plan for task force materials, which includes Issues Summary Packages and final minutes of meetings.

The FASB prepares an EITF Summary, which provides the following for each issue considered by the EITF:

- Description of issue
- Dates discussed/minute references
- Disposition, consensus reached, FASB/SEC document released, other

In addition, issues are grouped by type.

The professional researching an accounting issue can obtain from the FASB an EITF Summary and Analysis of Issues Grouped by Type to see if the task force might have already addressed a particular problem. Summary packets and minutes can be ordered individually from the FASB. The AICPA NAARS data base contains task force minutes and issues summaries, as well as the index to the issues and their dispositions. The FASB also publishes EITF Abstracts, which summarize the task force's proceedings. A separate abstract is presented for each issue considered by the task force. A comprehensive topical index facilitates quick identification of relevant issues.

HOW TO USE EITF POSITIONS

Statement on Auditing Standards (SAS) No. 52, *Omnibus Statement on Auditing Standards–1987*, provides the following hierarchy of generally accepted accounting principles:

- The first level includes standards enforceable under Rule 203 of the AICPA's Code of Professional Conduct, such as FASB statements and Accounting Principles Board (APB) opinions.
- If guidance is not found at the first level, the accountant will look to pronouncements that are not enforceable under Rule 203 but instead are the works of bodies of experts following a due process procedure. A significant due process effort includes the broad distribution of the proposed accounting principles for public comment, with the intent to establish accounting principles or describe existing practices that are generally accepted. Examples are FASB Technical Bulletins and AICPA Statements of Position.
- The next level includes practices or pronouncements that are widely recognized as generally accepted because they represent (1) prevalent practices in a particular industry or (2) the knowledgeable application to specific circumstances of pronouncements that are generally accepted.
- The last level, "other accounting literature," includes AICPA issues papers, EITF minutes, textbooks, and articles.

While an EITF consensus position is not enforceable under Rule 203, it does hold a place in the hierarchy of generally accepted accounting principles. Since consensus positions of the EITF represent the best thinking in areas in which there are no specific standards, the chief accountant of the SEC has indicated that registrants will be challenged if departing from these positions. Nonpublic companies should also heed this guidance, since the research efforts involved in resolving an issue are heavily reliant on analogies.

HOW TO CONFIRM ACCOUNTING PRACTICE TO THAT IN AN EITF CONSENSUS

Since the EITF is not a standard-setting body, it doesn't address, and ultimately specify, transition provisions. Under APB 20, a change in accounting principle that is voluntarily adopted would normally be reported as a cumulative catch-up adjustment in the year of the change.

Under SFAS 20, entitled *Reporting Accounting Changes Under* AICPA *Statements of Position*, the Board specified that transition provisions specified in a statement of position (SOP) would override APB 20. However, if unspecified in the SOP, then the cumulative catch-up adjustment would apply. Again, for EITF consensus rulings, APB 20 applies.

ANALYSIS OF SELECTED ISSUES

The following section reviews selected issues discussed by the EITF over the past year that are of interest to nonpublic companies. The section is arranged by type of issue, including the following:

- Inventory/fixed assets/leases
- Real estate
- Pensions/employee benefits
- Business combinations/new basis
- Other

Inventory/Fixed Assets/Leases

EITF 89-13—Accounting for the Cost of Asbestos Removal

A property owner, in compliance with federal, state, or local laws, incurs costs to remove or contain dangerous asbestos in buildings, in a manner specified in regulations.

The issues involved are as follows:

- Should the costs incurred to treat asbestos when a property with a known asbestos problem is acquired be capitalized or charged to expense?
- Should the costs incurred for an existing property be capitalized or charged to expense?
- If expensed, should the costs be reported as an extraordinary item?

Property Acquired. Costs incurred to treat asbestos within a reasonable time period after acquisition of a property with a known asbestos problem should be capitalized as part of the property cost, subject to an impairment test.

Existing Property. Costs incurred to treat asbestos on an existing building may be capitalized as a betterment, subject to an impairment test. Costs incurred in anticipation of selling the property should be deferred and recognized in the period of sale to the extent they will be recovered in the selling price.

Not Extraordinary. Asbestos treatment costs that are expensed should not be classified as extraordinary.

Disclosure. The SEC chief accountant noted that regardless of accounting treatment, disclosure is required in the MD&A of significant exposure for asbestos treatment.

[*Note:* The Task Force confirmed this consensus in EITF 90-8.]

EITF 89-16—Consideration of Executory Costs in Sale-Leaseback Transactions

Executory costs (insurance, maintenance, taxes) of property leased in a sale-leaseback transaction may be paid (a) by the buyer-lessor and recovered in the rental or billed separately to the seller-lessee, or (b) by the seller-lessee directly.

The issue is whether executory costs in a sale-leaseback should be included or excluded in the calculation of the profit to be deferred.

Treatment of Executory Costs. Executory costs should be excluded from the calculation of profit to be deferred irrespective of who pays the executory costs or the classification of the leaseback.

EITF 89-17—Accounting for the Retail Sale of an Extended Warranty Contract in Connection with the Sale of a Product

Some retailers offer separately priced extended warranty contracts that extend or enhance the manufacturer's warranty. The cost of fulfilling the contracts is minor in relation to the contract price and can be estimated with great reliability. The contracts are noncancellable unless the product is returned.

The issue involves the recognition of revenue and cost under the extended warranty.

Methods of Recognition. Three methods of recognition were discussed:

- *Full accrual:* Contract revenue is recognized at point of sale and estimated future warranty costs are accrued.
- *Full deferral:* Contract revenue is recognized in income over the life of the contract, and direct costs are expensed as incurred.
- *Partial recognition:* A portion of the contract revenue is recognized immediately, the remainder is deferred and is recognized over the life of the contract. The portion deferred covers estimated future cost plus a profit margin. Direct costs are expensed as incurred.

Full Accrual Rejected. Although the Task Force rejected the full accrual method, it did not reach a consensus on the other two methods, noting that both were used in practice. Subsequently, the Board authorized the FASB Staff to prepare a Technical Bulletin on this topic.

SEC Position. The SEC Chief Accountant indicated that the use of the partial recognition method would be appropriate only if the transaction meets all the following conditions:

- The extended warranty contract is sold simultaneously with the product to a substantial portion of customers.
- No substantive services apart from extension of the warranty are required to be performed under contract.
- Sales of warranty contracts (including renewals) unaccompanied by product sales are *de minimis.*
- The profit margin on the extended warranty contract is unusually high in comparison to the profit margin on the product. Estimated costs to be incurred under the extended warranty contract are nominal in relation to the combined price and can be estimated with a high degree of reliability.
- The contract is noncancellable and the customer's payment for the contract is nonrefundable, except upon return of the product.
- The amount deferred should be no less than the amount that would have been required to pay an independent third party to

assume the company's obligations under the extended warranty contracts.

The SEC Chief Accountant further noted that, when the partial recognition method is appropriately used, the amounts of revenue recognized and deferred, as well as the impact on trends, when material, should be specifically disclosed.

EITF 90-8—Capitalization of Costs to Treat Environmental Contamination

A company incurs environmental contamination treatment costs. The costs may include expenditures for removal of contamination, for acquiring tangible property, for environmental studies, and for fines.

The issue is whether such costs should be capitalized or charged to expense. The EITF did not deal with issues of recognition, measurement, or statement presentation.

General Principle. In general, environmental contamination treatment costs should be charged to expense.

Capitalization. The costs of environmental contamination treatment may be capitalized if recoverable only if one of the following criteria is met:

- The costs extend the life, increase the capacity, or improve the safety or efficiency of the property owned by the company.
- This criterion requires that the condition of the property be improved.
- The costs mitigate or prevent future environmental contamination that would otherwise result from future operations. Also, the costs improve the condition of the property.
- The costs are incurred to prepare for sale of property held for sale.

Application. Examples of the application of the consensus appear in Exhibit 6-1, which is reproduced with permission from the FASB.

Exhibit 6-1 ***Samples of the Application of the Consensus on EITF Issue 90-8***

Environmental Contamination, Treatments	*Evaluation of Criteria*
1. Tanker Oil Spill:	
A. Clean up waterway and beachfront.	1. Costs to clean up the waterway and beachfront are not eligible for consideration under the first criterion because the oil company does not own the property. 2. The cleanup of the waterway and beachfront does not mitigate or prevent a future oil spill from future operations. 3. The waterway and beachfront are not owned assets and, therefore, the third criterion does not apply. *Conclusion:* Costs incurred for cleanup and restoration in connection with the oil spill should be charged to expense.
B. Reinforce tanker's hull to reduce risk of future spill.	1. Reinforcing the hull improves the tanker's safety compared to when the tanker was originally constructed or acquired. 2. Reinforcing the hull mitigates the risk that the tanker will experience a similar oil spill during future operations and improves the tanker's safety compared to when the tanker was originally constructed or acquired. *Conclusion:* The costs incurred in connection with reinforcing the tanker's hull may be capitalized under either the first or second criterion.
2. Rusty Chemical Storage Tank:	
A. Remove rust that developed during ownership.	1. Removing the rust has not improved the tank compared with its condition when built or acquired.

Exhibit 6-1 *(cont.)*

Environmental Contamination, Treatments	*Evaluation of Criteria*
	2. Removing the rust has mitigated the possibility of future leaks. However, removing the rust has not improved the tank compared with its condition when built or acquired. *Conclusion:* Rust removal costs should be expensed unless the tank is currently held for sale and the costs were incurred to prepare the tank for sale.
B. Apply rust prevention chemicals.	1. The application of rust prevention chemicals has improved the tank's condition compared with its condition when built or acquired. 2. Rust prevention chemicals mitigate the possibility that future rust will cause leaks and also improve the tank's condition compared with its condition when built or acquired. *Conclusion:* The costs of applying the rust prevention chemicals may be capitalized under either the first or second criterion.
3. Air Pollution Caused by Manufacturing Activities:	
A. Acquire and install pollution control equipment.	1. The pollution control equipment improves the safety of the plant compared with its condition when built or acquired. 2. The pollution control equipment mitigates or prevents air pollution that has yet to occur but that may otherwise result from future operation of the plant and improves the safety of the plant compared with its conditions when built or acquired. *Conclusion:* Costs associated with acquisition and installation of the pollution con-

Exhibit 6-1 ***(cont.)***

Environmental Contamination, Treatments	*Evaluation of Criteria*
	trol equipment may be capitalized under either the first or second criterion.
B. Pay fines for violations of the Clean Air Act.	1. Payment of fines does not extend the plant's life, increase its capacity, or improve its efficiency or safety. 2. Payment of fines does not mitigate or prevent pollution that has yet to occur but that may otherwise result from future operation of the plant. *Conclusion:* Fines paid in connection with violations of the Clean Air Act should be charged to expense. Even if the plant is currently held for sale, the fines should be charged to expense because the costs would not have been incurred to prepare the plant for sale.
4. Lead Pipes in Office Building Contaminate Drinking Water:	
A. Remove lead pipes and replace with copper pipes.	1. Removing the lead pipes has improved the safety of the building's water system compared with its condition when the water system was built or acquired. 2. By removing the lead pipes, the building's owner eliminated an existing environmental problem and prevented any further contamination from *that* lead. However, by removing the existing pipes, the building's owner has *not* mitigated or prevented environmental problems yet to occur, if any, from future operation of the building. *Conclusion:* Costs to remove the lead pipes and install copper pipes may be capitalized under the first criterion. The book value of the lead pipes should be charged to expense when removed.

Exhibit 6-1 *(cont.)*

Environmental Contamination, Treatments	*Evaluation of Criteria*
5. Soil Contamination Caused by an Operating Garbage Dump:	
A. Refine soil on dump property.	1. The life of a garbage dump is not extended by refining its soil. Further, the condition of the soil after refining will not be improved over its condition when the garbage dump was constructed or acquired. Removal of the toxic waste restores the soil to its original uncontaminated condition. 2. Removal of toxic waste from the soil addresses an existing environmental concern. It also prevents that waste from leaching in the future. However, removing the waste does not mitigate or prevent future operations from creating future toxic waste. The risk will continue regardless of how much of the existing soil is refined. *Conclusion:* Soil refinement costs should be charged to expense unless the garbage dump is currently held for sale and the costs were incurred to prepare the garbage dump for sale.
B. Install liner.	1. The liner does not extend the useful life or improve the efficiency or capacity of the garbage dump. However, the liner has improved the garbage dump's safety compared to when the dump was constructed or acquired. 2. The liner addresses an existing and potential future problem. In this example, the garbage dump contains toxic waste from past operations and will likely generate toxic waste during future operations. The liner partly addresses the exiting environmental

Exhibit 6-1 *(cont.)*

Environmental Contamination, Treatments	*Evaluation of Criteria*
	problem by preventing future leaching of existing toxic waste into the soil. The liner also mitigates or prevents leaching of toxic waste that may result from garbage dumping in future periods and has improved the garbage dump's safety compared to when the dump was constructed or acquired. *Conclusion:* The liner may be capitalized under either the first or second criterion.
6. Water Well Contamination Caused by Chemical That Leaked into Wells Containing Water That Will Be Used in Future Beer Production	
A. Neutralize water in wells.	1. The treatment does not extend the life of the wells, increase their capacity, or improve efficiency. The condition of the water is not safer after the treatment compared to when the wells were initially acquired. 2. By neutralizing the water, the possibility of future contamination of the wells from future operations has not been mitigated or prevented. *Conclusion:* Costs incurred to neutralize well water should be charged to expense unless the wells were held for sale and the costs were incurred to prepare the wells for sale.
B. Install water filters.	1. The water filters improve the safety of the wells compared with their uncontaminated state when built or acquired.

Exhibit 6-1 *(cont.)*

Environmental Contamination, Treatments	*Evaluation of Criteria*
	2. The water filters address future problems that may result from future operations. Since the water filters are effective in filtering environmental contamination, they mitigate the effect of spilling new contaminants into the wells during future operations. In addition, the water filters represent an improvement compared with the wells' original condition without water filters. *Conclusion:* The water filtering system may be capitalized under either the first or the second criterion.
7. Underground Gasoline Storage Tanks Leak and Contaminate the Company's Property	
A. Refine soil.	1. Soil refinement does not extend the useful life, increase the capacity, or improve the efficiency or safety of the land relative to its unpolluted state when acquired. 2. By refining the contaminated soil, the oil company has addressed an existing problem. However, the company has not mitigated or prevented future leaks during future operations. *Conclusion:* Soil refining costs should be charged to expense unless the property is currently held for sale and the costs were incurred to prepare the property for sale.
B. Encase tanks so as to prevent future leaks from contaminating surrounding soil.	1. In some cases, encasement may increase the life of the tanks because of their increased resistance to corrosion, leaking, etc. In other situations, the treatment may not increase the life of

Exhibit 6-1 ***(cont.)***

Environmental Contamination, Treatments	*Evaluation of Criteria*
	the tanks. However, the encasement has improved the tanks' safety compared with their condition when built or acquired. 2. Encasement has mitigated or prevented future leakage and soil contamination that might otherwise result from future operations. In addition, the encasement has improved the tanks' safety compared with their condition when built or acquired. *Conclusion:* The cost of encasement may be capitalized under either the first or the second criterion.
8. Air in Office Building Contaminated with Asbestos Fibers	
A. Remove asbestos.	1. Removal of the asbestos improves the building's safety over its original condition since the environmental contamination (asbestos) existed when the building was constructed or acquired. 2. By removing the asbestos, the building's owner has eliminated an existing environmental problem and has prevented any further contamination from *that* asbestos. However, by removing the existing asbestos, the building's owner has not mitigated or prevented new environmental problems, if any, that might result from future operation of the building. *Conclusion:* Asbestos removal costs may be capitalized as a betterment under the first criterion.

Source: FASB, EITF 90-8 "Capitalization of Costs to Treat Environmental Contamination" (Norwalk, Conn.: Financial Accounting Standards Board, 1990). Reprinted with permission.

Real Estate

EITF 89-14—Valuation of Repossessed Real Estate

A seller finances the sale of real estate to the buyer. Seller records a sale but recognizes profit on the installment or cost recovery methods. Later, the buyer defaults on the mortgage to the seller and the seller forecloses on the property. At that date, the fair value of the property is less than the gross receivable, but greater than the net receivable (gross receivable, principal, and interest, less deferred profit on the sale and related allowances).

The issue is the value at which the foreclosed property should be recorded.

Value or Repossession. The property should be recorded at the lower of the net amount of the receivable or fair value of the property. Of course, this assumes that the accrual of interest is appropriate under the circumstances. SFAS 15 title does not apply because the deferred profit is not considered a valuation account in the context of SFAS 15. SFAS 15 would apply, however, to a foreclosure to a sale recorded under the full accrual method.

Pensions/Employee Benefits

EITF 89-11—Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan

Employer securities held by participants in an employee stock ownership plan (ESOP) that are not readily tradable on an established market must, under federal tax laws, include a put option. The put option gives the participant the right to demand that the sponsor redeem the shares. The employer may have the option to issue marketable securities in lieu of cash. Although the provisions of the ESOP may permit the ESOP to act as the buyer, the sponsor cannot require the ESOP to assume the put obligation.

The issue is, in a leveraged ESOP, if securities are classified outside of permanent equity, should any of the debit in the equity section (deferred compensation) be similarly classified?

Debit Classification When some or all of the securities must be classified outside of permanent equity, a proportional amount of the debit in the equity section of the sponsor's balance sheet should be similarly classified. According to the SEC, the sponsor must reflect outside of permanent equity the maximum possible cash obligation related to those securities where holders of the equity securities may demand cash. Thus, securities held by an ESOP must be reported outside of permanent equity if by their terms they can be put to the sponsor for cash.

EITF 89-12—Earnings-per-Share Issues Related to Convertible Preferred Stock Held by an Employee Stock Ownership Plan

A sponsor issues high-yield convertible preferred stock to an ESOP, which the ESOP finances with debt. The debt is serviced by dividends and sponsor contributions. The dividends paid on the preferred stock are charged to retained earnings.

The preferred stock is redeemable by the sponsor at initial value by cash, common stock, or a combination of the two. The preferred stock is also convertible into a fixed number of common shares. Further, the sponsor may guarantee that participants will receive at least the redemption price upon termination or retirement in cash or stock.

The issues involve the calculation of earnings per share (EPS) under the if-converted method:

1. Is convertible preferred stock issued to an ESOP a common stock equivalent?
2. If conversion is assumed, should net income be reduced by an additional ESOP contribution that would be necessary to meet the debt service requirement?
3. If employees are guaranteed a value equal to the redemption price, should the number of shares assumed to be outstanding be increased if the market price of the underlying common stock decreases and is less than the redemption price?
4. Would the answer to issue 3 differ if the redemption price guarantee can be satisfied by paying cash?

The Task Force consensuses on these issues are as follows:

Not Common Stock Equivalent. The convertible preferred stock issued to an ESOP is not common stock equivalent unless it meets the yield test (less than 66⅔ percent of Corporate Aa bond rate).

Reduce Net Income. As to issue 2, net income should be adjusted by the difference between the amount of the current preferred dividend and the amount of dividends on the common shares considered outstanding under the if-converted method.

Guaranteed Value. Under the if-converted method, the EPS calculation should include the number of shares assumed to be issued based on the conversion rate for unallocated shares plus the number of shares that would be based on the redemption value, but not less than the stated conversion rate for convertible shares that have been allocated to participants as of the reporting date.

Cash Option. If the sponsor has the ability and intention to satisfy the guarantee in cash, only the stated conversion rate should be used, and no additional issuances of shares is assumed.

EITF 90-3—Accounting for Employers' Obligations for Future Contributions to a Multiemployer Pension Plan

An employer participates in a multiemployer defined benefit pension plan that requires certain future contributions to the plan upon initial entry or on improving benefits based on the plan's prior service costs associated with the participants entering the plan or improving benefits.

The issue is whether the employer must record a liability for the future payments for prior service cost.

No Liability. The only liability is for contributions currently due and unpaid.

EITF 90-4—Earnings per Share Treatment of Tax Benefits for Dividends on Stock Held by an Employee Stock Ownership Plan

A sponsor establishes an ESOP. Cash dividends on stock held by the ESOP are deductible for tax purposes and are reported as a credit directly to retained earnings.

The issue is whether dividends on preferred stock held by an ESOP should be deducted net of tax benefit in computing primary EPS.

Dividend on Preferred Stock. If the preferred stock is not a common stock equivalent, then the dividends should be deducted, net of the tax benefit, when computing primary EPS.

Business Combinations/New Basis

EITF 90-5—Exchanges of Ownership Interests Between Entities Under Common Control

Parent company transfers its shares of Sub B to Sub A in exchange for additional Sub A shares. Parent's investment in Sub B differs from the underlying net assets on Sub B's financial statements. (Push-down accounting had appropriately not been applied.)

The issues are as follows:

- Should the consolidated statements of Sub A include the assets and liabilities of Sub B at the historical cost in Sub B's financial statements or at the historical cost in Sub A's parent company consolidated statements?
- Does the amount assigned to the acquisition of a minority interest in Sub B by Sub A depend on whether Sub A uses cash or stock?

Consolidated Statements—Sub A. The consolidated statements of Sub A should reflect the assets and liabilities of Sub B at the historical cost in the consolidated financial statements of Sub A's parent. The parent is transfering Sub B, therefore its basis is the historical cost. Sub A must be a substantive, operating company.

Acquisition of a Minority Interest. The acquisition by Sub A of a minority interest of Sub B should be accounted for by the purchase method as an acquisition in the consolidated statements of Sub A, regardless of whether cash or stock is used. (See TB 85-5.) If, however, the exchange lacks substance, existing carrying amounts should be used.

EITF 90-12—Allocating Basis to Individual Assets and Liabilities for Transactions Within the Scope of Issue No. 88-16

Issue No. 88-16, *Basis in Leveraged Buyout Transactions*, establishes the method for determining the basis of NEWCO's investment in OLDCO if there is a 100-percent purchase acquisition. Issue 88-16, however, did not address allocation of the investment to individual assets and liabilities, which is necessary to prepare NEWCO's consolidated financial statements.

The issue in 90-12 is how the investment should be allocated in an LBO (leveraged buyout) transaction in which a portion of NEWCO's investment in OLDCO is valued at predecessor basis.

Step Acquisition. NEWCO's basis in OLDCO should be allocated to individual assets and liabilities in a manner similar to a step acquisition (partial purchase method).

The SEC staff has indicated that despite the step acquisition approach, if there is a NOL carryforward in such cases, the entire amount should be viewed as an acquired carryforward.

EITF 90-13—Accounting for Simultaneous Common Control Mergers

Company A (parent) acquires a controlling interest in Company B. Almost simultaneously, Company B issues additional shares to Company A in exchange for Company A's interest in a subsidiary in the same line of business as Company B. All three entities are substantive operating companies.

The issues are as follows:

1. Should Company A account for the transfer of the subsidiary to Company B as part of the purchase of Company B, or as a "pooling-of-entities under common control" in accordance with Accounting Interpretation No. 39?
2. If the transaction is viewed as a purchase and accounted for at fair value, (a) Should a gain be recognized by Company A? and (b) How should the transaction be accounted for by Company B?

Accounting Inerpretation No. 39. AICPA Accounting Interpretation No. 39 indicates that APB Opinion No. 16, *Business Combinations*, does not apply to a transfer of net assets or to an exchange of shares between companies under common control. Nevertheless, Interpretation No. 39 states that transfers such as the following should be accounted for at historical cost in a manner similar to that of a pooling-of-interests accounting.

- Parent company transfers its interest in several partially owned subsidiaries to a new wholly owned subsidiary, which is a change in legal organization but not in the entity.
- 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.

Single Transaction. Interpretation No. 39 does not apply in this case, and Company A should account for the transfer to Company B as a purchase of Company B under APB Opinion No. 16. Where the transfer of the subsidiary to Company B is negotiated in conjunction with obtaining control of Company B, the two steps should be viewed as a single transaction.

Partial Sale. On Issue 2(a), the transaction should be accounted for by the parent as a partial sale of the subsidiary to the minority shareholders of Company B and a partial acquisition of Company B. Therefore, gain or loss would be recognized on that portion treated as sold.

The Task Force was not asked to reach a consensus on the accounting by Company B.

Other

EITF 89-2—Maximum Maturity Guarantees on Transfers of Receivables

A company transfers receivables with recourse in a transaction that qualifies as a sale under SFAS 77. At a specified date, when it is expected that the remaining receivables will be a minor percentage of the original amount transferred, the purchaser has the right to sell (put) the balance to the seller, or the seller has the right to purchase (call) the receivables. SFAS 77 permits sales treatment of the transfer under such terms.

The issue is whether an expectation that the outstanding balances will be minor may be based on the seller's estimate of prepayments if the balances will not be minor based on contractual payment terms.

Contractual Terms. In order for the terms of a put or call not to violate SFAS 77, outstanding balances must be estimated to be minor at a future exercisable date based solely on contractual repayment terms.

APPENDIX A

Emerging Issues Task Force
Issues Grouped by Type
(July 12, 1990)

Income taxes	22
Financial institutions	32
Financial instruments	53
Off-balance-sheet financing	12
Pensions/employee benefits	23
Business combinations/new basis	28
Inventory/fixed assets/leases	20
Real Estate	9
Other	20
Total	219

APPENDIX B

Emerging Issues Task Force Disposition of Issues (July 12, 1990)

Resolved by the FASB	24
Resolved by the SEC	4
Resolved by the AICPA	2
FASB staff work in progress	2
AICPA committee work in progress	1
Issue to be addressed within an existing FASB major project	6
Consensus was reached on the accounting	151
No resolution	24
Further discussion by the Task Force is pending	5
Total	219

CHAPTER 7

Overview of AICPA Technical Inquiries, Accounting Standards Division Statements of Position, and Practice Bulletins

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Overview of AICPA Technical Inquiries, Accounting Standards Division Statements of Position, and Practice Bulletins

INTRODUCTION

Accounting guidance is also available through the AICPA in the form of Technical Practice Aids, Accounting Standards Division Statements of Position, and Accounting Standards Executive Committee (AcSEC) Practice Bulletins.

AICPA Technical Practice Aids, Volume 1, summarizes the most troublesome and frequently encountered questions and problems submitted to the AICPA's Technical Information Service. Each inquiry includes a statement of problem, recommendations made by the AICPA Staff and references to relevant standards and other authoritative literature. Inquiries are organized by subject and indexed.

The Accounting Standards Division of the AICPA issues Statements of Position with the stated purpose 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.

In November 1987, the AICPA issued Practice Bulletin 1, which announced that the AcSEC will, when necessary, publish AcSEC Practice Bulletins. Such bulletins provide practitioners and preparers with guidance on narrow financial accounting and reporting issues. (Previously, AcSEC released its views on such issues through the CAP *Letter* and the *Journal of Accountancy*.) The issues are limited to those that the Financial Accounting Standards Board

(FASB) and the Governmental Accounting Standards Board (GASB) have not or will not address.

Drafts of Practice Bulletins are neither exposed for public comment nor are they the subject of public hearings. However, they are discussed at open meetings of AcSEC and are included with agenda papers for such meetings. For publication, a Practice Bulletin requires approval by two-thirds of AcSEC members. Before publication, the FASB and GASB are given the opportunity to review the Practice Bulletin and then inform AcSEC that they have no intention of considering the issue. Practice Bulletins are numbered to facilitate reference and retrievability, and, on issuance, are distributed to practice units and other interested parties.

Amendments of Practice Bulletins require the same procedures as those for issuing a new Practice Bulletin.

Technical Practice Aids, AcSEC Statements of Position, and AcSEC Practice Bulletins are not covered by Rule 203 of the AICPA Code of Professional Conduct. Their places in the hierarchy of generally accepted accounting principles are established through Statement on Auditing Standards No. 5, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report,* as amended by Statement on Auditing Standards No. 43, *Omnibus Statement on Auditing Standards.* AICPA Accounting Statements of Position are specifically mentioned as belonging at the second level within the hierarchy, which is works of experts following a due process procedure. Technical Inquiries and Practice Bulletins fall within the lowest level of the hierarchy, which is other accounting literature.

In September 1979, Statements of Financial Accounting Standards (SFAS) 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters,* as amended, specifies that specialized accounting and reporting principles and practices in designated AICPA Statements of Position are preferable accounting principles for applying APB Opinion 20, *Accounting Changes.* Under FASB interpretation 20, *Reporting Accounting Changes Under AICPA Statements of Position,* the FASB specified that transition provisions in a Statement of Position override APB 20. However, if a transition is unspecified in the Statement of Position, then the cumulative catch-up adjustment would apply.

If the FASB, GASB, or predecessor bodies have not ruled on a given transaction, privately held companies and, of course, publicly held companies should look to and would clearly do well to look to Technical Practice Aids, Accounting Statements of Position, and AcSEC Practice Bulletins as sources of Generally Accepted Accounting Principles (GAAP). This chapter concentrates on Technical Practice Aids, Accounting Statements of Positions, and AcSEC Practice Bulletins recently published that have general applicability.

AICPA TECHNICAL PRACTICE AIDS—SELECTED QUESTIONS

The following inquiries and replies on selected practice problems are directly excerpted from AICPA, *Technical Practice Aids*, Vol. 1, TIS Sections 1,000–5,000, 7,000 (New York: AICPA, 1989 and 1990).

Financial Statement Presentation

Statement of Cash Flows

Classification of Increase in Cash Value of Officers' Life Insurance in Statement of Cash Flows

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

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

Presentation of Discontinued Operations in the Statement of Cash Flows

Inquiry—A CPA is preparing a statement of cash flows for a client company. During the year, the company disposed of a segment of its business. How would the gain or loss on disposal of a segment of a business be presented on the statement of cash flows?

Reply—According to SFAS 95 *Statement of Cash Flows*, paragraph 16c, cash inflows from investing activities include "receipts from sales of property, plant, and equipment and other productive assets." The cash proceeds from the disposal of the segment would be accounted for in this manner. The gain or loss on the disposal of discontinued operations would be an adjustment to be included in the reconciliation of net income to net cash provided by operating activities.

Presentation of Cash Overdraft on Statement of Cash Flows

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

Reply—The amount that will be shown on the statement of cash flows is the two accounts with the positive balances. Per SFAS 95, *Statement of Cash flows*, paragraph 7, "The total amounts of cash and cash equivalents at the beginning and end of the period shall be the same amounts as similarly titled line items or subtotals shown in the statements of financial position..." The net change in overdrafts during the period is a financing activity.

Assets

Temporary Investments

Depreciation on Building Held for Investment

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

Reply—ARB No. 43, Chapter 9, *Depreciation*, states that generally accepted accounting principles require that the cost of a productive facility 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.

The building should not be depreciated because it is not being used as a productive facility and no services will be derived from it. However, the corporation should carry the building at lower of cost or net realizable value on its balance sheet.

Balance Sheet Classification of Revolving Line of Credit

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

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

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

Uncertainty Arising From Violation of Debt Agreement

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

Reply—SFAS 78, *Classification of Obligations That Are Callable by the Creditor*, states that the current liability classification is intended to include long-term obligations that are or will be callable by the creditor because the debtor either violates the debt agreement or does not cure a violation within a specified grace period. Accordingly, such callable obligations should be classified as current liabilities unless the creditor waives or loses the right to demand payment.

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

Contingent Liabilities

Accrual of Loss Contingency Arising from Judgment Under Appeal

Inquiry—Prior to the balance sheet date, a lower court adjudicated a case against a client company and set an award. The company is appealing the decision.

Is the company required to accrue a loss pursuant to the lower court's decision and determination of damages?

Reply—In accordance with SFAS 5, *Accounting for Contingencies*, it is appropriate to accrue a loss if the client company has lost the litigation and it is probable that the damages will be payable. However, in certain unusual circumstances, the lower court's decision alone may not meet the criteria of SFAS 5. Instead, the outcome of the appeal may be so uncertain that it is not probable there will be a loss. Accordingly, it may be acceptable to disclose the fact that the case was lost in the lower court and the amount of the judgment without accruing a loss unless and until the decision is upheld in the higher court.

Deferred Credits

Grant Received from Government to Purchase Fixed Assets

Inquiry—A nonpublic company received a grant from the Small Business Administration for the purpose of purchasing fixed assets. How should the grant be accounted for?

Reply—The AICPA Issues Paper, *Accounting for Grants Received from Governments* (10/16/79), contains an advisory conclusion (par. 40), that grants related to depreciable fixed assets should be recognized as income over the useful lives of the assets. In accordance with that advisory conclusion the company should record deferred revenue for the amount of the grant and recognize the revenue over the estimated useful life of the related fixed assets. The pattern of revenue recognition should be symmetrical to the method of depreciation.

Revenue and Expense

Cost Allocation

Sale of Research and Development Technology

Inquiry—A company has incurred material research and development costs in the current year. Subsequent to the balance sheet date but prior to issuance of the financial statements, the company commenced negotiations and sold the research and development technology to an unrelated company. May the company capitalize the incurred research and development costs in its annual financial statements in light of the subsequent sale?

Reply—SFAS 2, *Accounting for Research and Development Costs*, paragraph 12, states that research and development costs should be expensed when incurred. There is no justification for capitalizing the costs because the technology will be sold. The company should disclose the subsequent sale of the research and development technology in the footnotes to its financial statements if the amount is material.

Other Expenses

Accounting for Relocation Costs

Inquiry—A corporation is relocating its production facilities to a different location. May the costs of relocating be capitalized?

Reply—Practice varies. One of the primary characteristics of an asset as defined by SFAS 6, *Elements of Financial Statements*, is that an asset embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows. The costs of relocation do not embody any future benefit, and they should therefore be expensed when incurred. However, some companies routinely defer costs of relocation over a short period, usually not more than three years.

Specialized Industry Problems

Finance Companies

Amortization of Discount on Receivables of Consumer Finance Companies

Inquiry—A client in the consumer finance business loans money for short periods of time. What method should be used to amortize discounts on such loans?

Reply—In determining income from loans receivable which have been issued at a premium or discount, the required method of income recognition for any such premium or discount is the interest method, as described in SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* and as required by the AICPA Audit and Accounting Guide, *Audits of Finance Companies* (1988).

Method of Recognizing Revenue from Finance Charges

Inquiry—A finance company would like to establish a policy of recognizing 15 percent of the finance charges on discount loans as revenues in the first month of the loan and recognizing the balance of such charges as yield adjustments as the receivables are liquidated. Is this an acceptable method of recognizing revenues from finance charges?

Reply—No. The 1988 AICPA Audit and Accounting Guide, *Audits of Finance Companies,* requires that the interest (actuarial) method should be used to account for interest income in accordance with SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases.* In addition, SFAS 91, paragraph 5, requires that certain direct loan acquisition costs be deferred and treated as yield adjustments in applying the interest method.

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 interest method.

How should the service charge be recognized on the records of the company?

Reply—In accordance with the AICPA Audit and Accounting Guide, *Audits of Finance Companies* (1988), the service charge should also be recognized in income over the life of the related loan as an adjustment of yield using the interest method in accordance with SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*

Method of Recognizing Revenue from Commissions on Loan Insurance

Inquiry—A finance company receives commissions for loan insurance. How should the company recognize commission revenues?

Reply—The AICPA Audit and Accounting Guide, *Audits of Finance Companies* (1988), page 73, states that insurance commissions received by finance companies from independent insurers should be credited to a deferred income account when received and systematically amortized to income over the life of the related insurance contracts. The method of commission amortization should be consistent with the method of premium income recognition for that type of policy in accordance with SFAS 60, *Accounting and Reporting by Insurance Enterprises.*

Specialized Organizational Problems

Not-For-Profit Organizations

Valuation of Free Booklets by Nonprofit Organization

Inquiry—A nonprofit organization prints booklets that it distributes to the public for free.

At what amount, if any, would the entity value the inventory of such publications on its financial statements?

Reply—To the extent that those publications embody a potential future benefit, their cost, if material, should be recorded as a prepaid expense. The prepaid expense should be amortized as the booklets are distributed.

Purchase Method

Reduction of Carrying Value of Restricted Long-Term Equity Securities

Inquiry—Corporation P purchased Corporation S for a price substantially below the fair value of S Corporation's net assets. The sole assets of Corporation S are long-term equity securities which are restricted from being sold for a three-year period by a contractual agreement. Should these securities be reduced by a proportionate part of the excess fair value over cost?

Reply—Yes. APB Opinion No. 16, *Business Combinations*, paragraph 91, states that the values assigned to net assets acquired should not exceed the cost of the acquired company. An excess over cost should be allocated to reduce proportionally the values assigned to noncurrent assets (except long-term investments in marketable securities.)

FASB Interpretation No. 16, *Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable*, paragraph 6, states that if a restricted security cannot qualify for sale within one year or market price quotations are not available for unrestricted shares of the same class, the security is considered nonmarketable.

The equity securities owned by Corporation S should be reduced by a proportionate share of the excess fair value over cost because they are nonmarketable and do not meet the exception in APB Opinion No. 16, paragraph 91.

Negative Goodwill in Unclassified Balance Sheet

Inquiry—APB Opinion No. 16, *Business Combinations*, paragraph 91, discusses an excess of acquired net assets over cost, which should be allocated to reduce proportionately the values assigned to noncurrent assets (except for long-term investments in marketable securities) in determining their fair values. What is the appropriate accounting in a situation involving an unclassified balance sheet?

Reply—The allocation process under APB Opinion No. 16, paragraph 91, would focus on the nature of the assets regardless of whether a classified or unclassified balance sheet is presented and would allocate the excess to long-lived assets, except for investments in marketable securities.

Development Stage Enterprises

Informative Disclosure for Subsidiary in Development State

Inquiry—A parent corporation has a wholly owned subsidiary which wholly owns a development stage corporation. If the development stage subsidiary does not issue separate financial statements, how would the parent meet the additional reporting requirements for a development stage company in the consolidated financial statements?

Reply—SFAS 7, *Accounting and Reporting by Development Stage Enterprises*, does not address presentation of cumulative data for consolidated companies. Under the above circumstances, assuming the financial position and results of operations of the subsidiary are material to the consolidated financial statements, it is recommended that the cumulative information for major accounts be presented in a footnote to the financial statements.

Other Specialized Organizational Problems

Cash Received by Subsidiary in Spin-Off

Inquiry—A parent company wishes to spin off a subsidiary to its public shareholders, and as part of the transaction the parent company provides to the subsidiary sufficient cash to pay for the cost of the transaction. How should the spun off subsidiary account for the cash received from the parent?

Reply—The spun off subsidiary should credit to equity the cash received from the parent as well as the net amount of assets and liabilities transferred by the parent at the parent's historical cost. The costs incurred by the subsidiary which directly relate to the spin-off transaction should be charged to equity.

ACCOUNTING STANDARDS EXECUTIVE COMMITTEE PRACTICE BULLETINS

Amortization of Discounts on Certain Loans—Practice Bulletin 6

Scope

This Practice Bulletin addresses the accounting and reporting by purchasers of loans for which undiscounted future cash collections will probably be insufficient to recover the face amount of the loan and contractual interest.

Acquisition of Such Loans. The Practice Bulletin applies to loans purchased in various ways including:

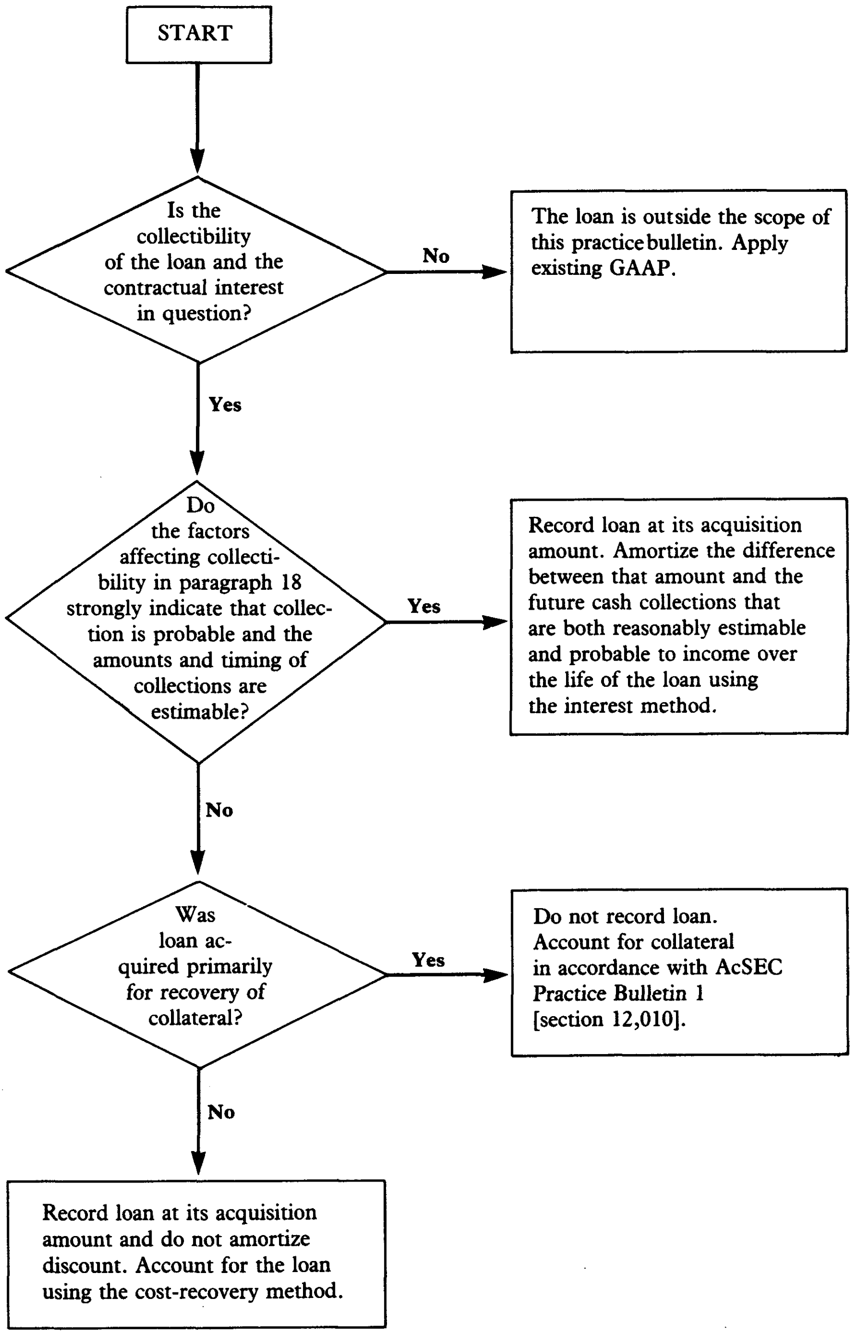
- Purchase business combinations
- Other loan acquisitions at a discount from face value.
- Transfer of loan value to a newly created subsidiary following write-down of loan to fair value with the ultimate intent of transferring stock of subsidiary to parent company as a dividend to shareholders.

Applicable Loan and Other Debt Instruments. Practice Bulletin 6 applies to corporate bonds, collateralized mortgage obligations, and securitized loans.

Practice Bulletin 6 is not applicable to loans carried at market value, lower of cost or market value, or loans held by liquidating banks.

Loans Held for Obtaining Underlying Collateral. Loans acquired for the purpose of obtaining the underlying nonmonetary collateral are measured using the value of that collateral. Applicable accounting and reporting guidance for loans entered into to obtain ownership of underlying assets may be found in SEC Financial Reporting Release No. 28, *Accounting for Such Loans by Registrants Engaged in Lending Activities* and Practice Bulletin No. 1, *Purpose And Scope of AcSEC Bulletins and Procedures for Their Issuance* (Exhibit 7-1, Accounting at the Date of Acquisition).

Exhibit 7-1 ***Accounting at the Date of Acquisition***



Accounting Guidance

Guidance on Amortization at Date of Acquisition. At the time of acquisition, the sum of the acquisition amount of the loan plus the discount to be amortized should not exceed the undiscounted future cash collections that are reasonably estimable and probable. Exhibit 7-1 summarizes the accounting at the date of acquisition.

Consideration of amount and timing of collections—If the amount and timing of collections are reasonably estimable and if collectibility of the acquisition amount of the loan and discount is probable, the discount is amortized over the period for which collections are probable. Amounts collected need not be allocated between interest and principal.

If these criteria are not met, the cost recovery method is to be used.

Seller of loan not recognizing interest—If the seller of a loan is not recognizing interest income because of concerns about collectibility of principal and interest payments, the foregoing criteria are presumed not to be met and cost recovery should be used.

If it is probable that the acquisition amount and discount will be collected and if the timing of collections is reasonably estimable, those presumptions can be overcome.

Discount amortization—The effective interest method is to be used to amortized discounts.

Guidance Subsequent to Acquisition. The purchaser of the loan must continue to evaluate the acquired loan throughout its life.

Estimate of probable collection is increased—If the estimated total probable collection is increased or decreased but still exceeds the carrying amount of the receivable, the amount of discount should be adjusted accordingly. The carrying amount of the loan receivable is the acquisition amount plus discount amortized to date less collections received to date.

The adjustment is a change in estimate accounted for under APB Opinion No. 20, *Accounting Changes*. The amount of periodic amortization is adjusted over the life of the loan.

Estimate of probable collection is reduced—If the amount probable of being collected is reduced and becomes less than the carrying amount of the loan, the loan should be written down or an allowance for uncollectiblity should be recognized.

Timing of collection changes—If the amount and timing of collection subsequently cannot be estimated, amortization should cease, and the cost recovery method should be used.

Collection is less than probable—If collection is less then probable, amortization should cease, and the loan should be recognized. The cost recovery method should then be used.

Subsequent decision that loan is held as nonmonetary collateral—If based on a subsequent determination, it is decided that a loan is held primarily for the underlying nonmonetary collateral, the loan should be accounted for using guidance on ADC arrangements as discussed in Practice Bulletin 1.

Application of Cost-Recovery Method. The cost-recovery method is implemented as follows:

- Amounts received are first applied against the recorded amount of the loan.
- When recorded amounts of the loan are reduced to zero, additional amounts are recognized as income.

Conditions for terminating cost recovery method—The cost-recovery method is used until it becomes apparent that the timing of collections is reasonably estimable and collection is probable. The carrying amount at this determination date is the acquisition amount reduced by collections and discount amortized to date, if any. If it is then determined that the revised remaining collectible amount exceeds the carrying amount of the loan, the difference should be amortized on a prospective basis over the life of the loan.

However, if the newly revised amount is determined to be less than the carrying amount, the loan should be written down or an allowance for uncollectibility should be recognized.

Factors in Assessing Collectibility of a Loan. The following factors should be considered in assessing collectibility of a loan:

- Financial condition of borrower
- Equity of borrower in underlying collateral
- Historical cash flows from loan

- Prospects of near term cash flows from loan
- Existence of irrevocable letters of credit, enforceable personal guarantees or takeout commitments from credit-worthy parties
- Nature of underlying assets and probability that assets will generate future cash flows to cover future principal and interest payments when due

Illustrative Cases

The following cases are designed to illustrate some of the accounting guidance set forth in this practice bulletin.

Case 1

A loan is acquired at a discount by Instant Credit Corp. Instant Credit Corp. has assessed future cash collection from this loan. The collection of principal and interest is probable, and amounts and timing of collections are reasonably estimable. The case first considers whether the discounts should be amortized. It then considers whether the discount should still be amortized if the loan, when acquired, was sixty days past due, and the amounts of interest and principal to be collected were still reasonably estimable and probable and were expected to be collectible within the next two years.

Solution—The loan acquisition entered into by Instant Credit Corp. is subject to this Practice Bulletin, since future cash collections are insufficient to recover the face amount of the loan plus future interest payments. Since the collections are probable, and the amount and timing of collection are reasonably estimable, the discount should be amortized using the effective-interest method. The loan's being past due at the time of acquisition does not modify this solution. Should subsequent to acquisition the loan become ninety days past due, the lender would have to reassess the conditions and cease amortizing the discount.

Case 2

The same past-due loan is acquired as in Case 1, but it is restructured with substantially reduced periodic principal repayments, a reduced-below-market-interest-rate, and a substantial balloon interest payment at maturity. There is no loss on restructuring. The borrower is making periodic interest and principal repayments. The case considers the accounting if this loan were restructured to require no interest with principal to be repaid in a single amount at maturity.

Solution—Due to the reduced principal repayments under the restructuring and the requirement of a substantial balloon payment, collectibility remains substantially in doubt. This loan does not meet the criteria for amortization of discounts. Additional evidence in support of probability of collection would have to be assessed before amortization of the loan could be justified. If the loan were to repaid totally at maturity with no interest payments, the discount should not be amortized.

Case 3

Instant Credit enters into the same past due loan as in Case 1. Interest payments are being made. Instant Credit believes a portion of the loan principal is probable, but the repayment of the remainder is less than probable.

Solution—The discount is measured as the difference between the acquisition cost and the sum of the principal payments and interest payments that are probable of collection and reasonably estimable. The discount is amortized over the life of the loan using the effective-interest-rate method. Periodic amortization is adjusted to reflect changes in estimates as to probability of collection.

ACCOUNTING STANDARDS DIVISION STATEMENTS OF POSITION

Financial Accounting and Reporting by Providers of Prepaid Health Care Services—Statement of Position 89-5

Scope

Providers of prepaid health care services have been found to use diverse approaches in accounting and reporting for health care costs, contract losses (premium deficiencies) stop loss insurance (reinsurance), and contract acquisition costs. The statement applies to providers of such health care services and is designed to narrow those accounting and reporting practices.

Definition of Providers of Prepaid Health Care Services

Prepaid health care providers are defined as "entities that provide or arrange for the delivery of health care services in accordance with terms and provisions of a prepaid health care plan." These providers assume the financial risk of the cost of delivery of such services, even if that cost exceeds the amount of fixed premiums received. Risk can be shared with other providers or reduced through the purchase of stop-loss insurance.

Health maintenance organizations (HMOs) are the most prevalent forms of prepaid health care providers.

Accounting for Health Care Costs

Definition of Health Care Costs. Health care costs are all costs of prepaid health care providers other than general and administrative, selling, maintenance, marketing, and interest.

Accruals and Disclosures of Health Care Costs. The Statement of Position (SOP) states that health care costs be accrued as services are rendered.

Estimates of cost of services rendered—An additional accrual should be made for the estimated cost services rendered but not yet reported.

Required services beyond premium period—Where the contract or regulatory requirements obligate the provider to render services to members beyond the premium period, costs of such services should be accrued currently.

Costs subsequent to contract termination—Upon the termination of a contract with a sponsoring employer or group, estimated costs still to be incurred on that contract should be accrued. These include such costs as guaranteed salaries, rent, and depreciation, net of estimated revenues.

Payables to hospitals, doctors, and other health care providers—An accrual should be made during the contract period for amounts payable to hospitals, physicians, and other health care providers for costs related to risk-retention, bonus, and other comparable programs. In determining the accrual, experience to date and other factors should be used to establish the amount of the accrual.

Disclosure of contractual arrangements—Policies for accruing health care costs, significant business and contractual arrangements with hospitals, doctors, and other entities should be provided in accompanying notes to financial statements.

Case 1: Illustration of Accrual of Costs in Premium Period

Premium period is the period to which a premium payment applies (ordinarily one month) that entitles a member to health care services according to contract provision.

Perpetual Stay Care HMO provides members with hospital care for hospital stays commencing during the premium period. Two patients are admitted to a hospital. The first patient, Jones, enters November 15, 19X1 and leaves the hospital December 10, 19X1. The second patient, Smith, enters December 2, 19X1 and leaves December 10, 19X1. Using these facts, this case shows the amount of Health Care costs to be accrued in the November premium period. The case then modifies the provisions of the contract to provide for days of a hospital stay within a premium period, and then determines the amount of health care costs that should be accrued in the November premium period.

Solution—In the case of Jones, the contract covers hospital care commencing during a period. Jones's illness commences in November but is expected to continue into December. An accrual should be made in November for the costs of the stay in December. In contrast, none of Smith's illness is attributable to the November premium period. If the contracts provide for days of stay within a premium period, none of the December hospital stay should be attributed to the November premium period.

Accounting for Loss Contracts

Contracts Where Anticipated Costs Exceed Anticipated Premiums. A loss is to be recognized when it is probable that expected future health care costs and maintenance costs under a group of existing contracts will exceed future premiums and stop-loss insurance.

Maintenance costs—These are costs of maintaining enrollments records and processing collection and payments.

Definition stop-loss insurance—This is a contract in which an insurance company agrees to indemnify providers against certain health care costs incurred by members.

Components of cost—Estimated future health care costs and maintenance costs in making the loss determination include fixed and variable, direct, and allocable indirect costs.

Group contracts in making loss determination—Contracts are grouped based on the provider's method for setting premium rates (for example, geographical area, statutory requirements, or community rating policies).

Accounting for Stop-Loss Insurance

Health care costs include stop-loss insurance—Stop loss insurance is to be included in reported health care costs. Recoveries are reductions in health care costs.

Recoverable amounts are assets—Receivables from insurers constituting amounts recoverable are reported as assets. An appropriate valuation allowance for uncollectibility is to be established.

Disclosures—The nature, amount, and effects of significant stop-loss insurance contracts are to be disclosed.

Accounting for Contract Acquisition Costs

Components of acquisition costs—Acquisition costs are marketing costs directly attributable to the acquisition of specific subscriber contracts and member enrollment and are incremental to general marketing activities. They can consist of commissions paid to agents and brokers and incentive compensation based on new enrollments as well as the costs of specialized brochures, marketing, and advertising. Costs related to the acquisition of new members may include salaries of marketing director and staff, general marketing brochures, general advertising, and promotion expenses.

Expense acquisition costs as incurred—The acquisition costs of providers of prepaid health care services should be expensed as incurred.

Effective Date

The SOP is effective for fiscal years beginning on or after June 15, 1989, with earlier application encouraged.

Transition

Where practical, SOP 89-5 is to be applied retroactively with restatement of any comparative financial statements included with the current period financial statements. The cumulative effect of applying the statement on those years not comparatively presented with the current year financial statements should be included in determining net income of the earliest year presented. Where it is impractical to restate any prior year, the cumulative effect should be included in net income in the year in which the statement is first applied. In the first year of application of the new statement, there should be disclosure of the nature of restatement, effect on income before extraordinary items, net income, and per share amounts for each year presented.

CHAPTER 8
SEC Staff Accounting Bulletins

CHAPTER 8
SEC Staff Accounting Bulletins

APPLICABILITY OF GUIDANCE

The United States Securities and Exchange Commission (SEC) Division of Corporation Finance and the Office of the Chief Accountant publish Staff Accounting Bulletins (SABs). The guidance in the bulletins is not SEC rules or interpretations thereof, nor are they published as bearing the commission's official approval; they represent interpretations and practices followed by the division and the chief accountant in administering the disclosure requirements of the federal securities laws. Registrants may be called on to justify departures from SABs. The SEC sets forth its views and interpretations of financial reporting practices in Financial Reporting Releases (initially published as Accounting Series Releases). The Financial Reporting Releases do not supplant the rules set forth in Regulation S–X, "Form and Content of Financial Statements," and regulation S–K, "Integrated Disclosure Rules," but only supplement those regulations. These publications prescribe the rules covering the filing of financial statements with the SEC. Thus, they apply to publicly held companies. Nevertheless, privately held companies may find some guidance in those publications useful.

The SEC itself has relied on the Financial Accounting Standards Board (FASB) and its predecessors to develop generally accepted accounting principles and has limited itself largely to matters of disclosure and other compliance matters. Nevertheless, on occasion the SEC or its staff finds it necessary to issue pronouncements on accounting issues on which the FASB or its predecessors have not yet acted. These pronouncements are considered part of the overall body of authoritative accounting literature on generally accepted accounting principles (GAAP). Thus, where the FASB or its predecessor bodies have not ruled on a given transaction, privately held companies might wish to, and publicly held companies must, look to SEC pronouncements on the subject as a source of GAAP.

This chapter concentrates on SABs published during the past year that may have general applicability.

EARNINGS PER SHARE COMPUTATIONS IN AN INITIAL PUBLIC OFFERING—SAB 83

SAB 83, published in July 1989, expresses the staff's view regarding the computation of earnings per share (EPS) where a registration statement is filed in connection with an initial public offering and during the periods covered by the income statements, the registrant issued common stock for consideration below the initial public offering (IPO) price or issued common stock warrants, options, or other potentially dilutive instruments with exercise prices below the IPO price.

Computing Earnings Per Share

The staff expressed the view that in computing EPS, stock and warrants issued for consideration below the IPO within a one-year period prior to the initial filing of the registration statement relating to the IPO should be treated as outstanding for all reported periods in the same manner as shares issued in a stock split or a recapitalization effected contemporaneously with an IPO. The treasury stock approach should be used in determining the dilutive effect of the issuance. The staff believes that the treasury stock method should be used for all prior periods, including loss years where the impact is anti dilutive.

Compensation Expense

The staff also expressed the view that reflecting the stock and warrants as outstanding for all historical periods in computing EPS does not alter the registrant's responsibility to determine whether compensation expense must be recognized on issuances of stock and warrants to employees. Under GAAP, the registrant must recognize compensation expense when the amount of any issuances of stock and warrants to employees is less than fair value.

ACCOUNTING FOR SALES OF STOCK BY A SUBSIDIARY—SAB 84

SAB 84, published in July 1989, amends SAB 51 on accounting for sales of a stock by a subsidiary. The issue centers on the treatment of the gain by a registrant when a 95 percent owned subsidiary sells its unissued shares in a public offering decreasing the registrant's ownership to 90 percent, and the selling price per share exceeds the registrant's carrying amount per share of subsidiary stock.

Gain Recognition

Although the staff had previously required that such transactions be accounted for as capital transactions in the consolidated balance statements, it has reconsidered those views and will allow inclusion of the gain in income. However, the sale of such shares by a subsidiary must not be part of a broader corporate reorganization contemplated or planned by the registrant.

Gain Not Recognized

The staff believes that gain recognition is not appropriate where subsequent capital transactions are contemplated that raise concerns about the likelihood of the registrant realizing that gain. In the following circumstances the gain would be accounted for as a capital transaction:

- Registrant intends to spin off its subsidiary.
- Reacquisition of shares is contemplated at the time of issuance.
- When shares are repurchased within one year of issuance or a plan to repurchase existed at that time, repurchase of shares is presumed to have been contemplated at date of issuance.
- Subsidiary is a newly formed, nonoperating entity.
- Subsidiary is a research and development, start-up, or development stage company.
- Subsidiary is an entity whose ability to continue in existence is in question.

Gain Recognition on Other Transactions

Gain may also be recognized with respect to issuance of stock options, warrants, and convertible and other similar securities. However, the gain should not be recognized before exercise or conversion of the securities into common stock, and provided realization is assured.

Repurchase of a Subsidiary's Shares

If previous gains have been recognized and shares of the subsidiary are subsequently repurchased by the subsidiary, its parent, or any other member of the consolidated group, gain should not be recognized on issuances subsequent to the date of repurchase until shares have been issued in an amount equivalent to the amount of repurchased shares. The staff views such transactions as analogous to treasury stock transactions.

Consistent Treatment

A registrant cannot selectively apply the guidance in the SAB. It cannot recognize in the income statement the impact of certain issuances by a subsidiary while recognizing other issuances as capital transactions. Income statement treatment represents a choice among alternative accounting methods and therefore must be applied consistently to all stock transactions that meet the conditions for income statement treatment. Thus, if gains are recognized in income, then losses must also be recognized in income. When a subsidiary issues securities at a price less than the registrant's carrying value, then the question of impairment must be investigated.

Statement Presentation

If gain is recognized in income, it should be presented as a separate line item in the consolidated income statement without regard to materiality and clearly desegregated as nonoperating income. The accounting method adopted by the registrant should be disclosed as should details about all such transactions. Disclosures should also be made whether deferred income taxes have been provided.

QUASI-REORGANIZATION—SAB 86

SAB 86, published in September 1989, expresses the staff's view on selected matters relating to accounting for a quasi-reorganization.

Deficit Reclassification

A deficit reclassification of any nature is considered to be a quasi-reorganization and may not be implemented unless all requisite conditions for a quasi-reorganization are satisfied. These conditions include evaluating the concurrent need to restate assets and liabilities to fair values.

Anticipated Change in Method

A company undergoing a quasi-reorganization should adopt anticipated discretionary accounting changes prior to or as an integral part of the quasi-reorganization. In addition, the staff believes that adopting a discretionary change in accounting principle that will be reflected in the financial statements within twelve months following the consummation of a quasi-reorganization leads to a presumption that the accounting change was contemplated at the time of the quasi-reorganization.

Asset Write-Up

A quasi-regorganziation should not result in a write-up of net assets of the registrant. The carrying amounts of individual assets may be written up to fair value. However, the amount of such increases is limited to offsetting adjustments to reflect decreases in other assets or increases in liabilities to reflect their new fair values.

Tax Benefit of Tax Loss Carryforward

Tax benefits of operating loss or tax credit carryforwards that existed as of the date of a quasi-reorganization should be reported as a direct addition to paid-in capital when realized. This position is consistent with the new company or fresh-start concept.

Reversing a Quasi-Reorganization

A company may not reverse or "undo" its quasi-reorganization. APB Opinion 20 precludes such a change in accounting because the quasi is a method adopted for a type of transaction or other event that is being terminated or that was a single, nonrecurring event in the past.

CONTINGENCY DISCLOSURES REGARDING PROPERTY CASUALTY—SAB 87

SAB 87, published in December 1989, expresses the staff's view on contingency disclosures regarding property casualty. In SAB 87, the staff furnishes an example in which specific uncertainties involving an individual claim or group of related claims result in a loss contingency that requires disclosure.

A property casualty insurance company (the company) underwrites product liability insurance for an insured manufacturer that has produced and sold millions of units of a particular product that has been used effectively and without problems for many years. Users of the product have recently begun to report serious health problems that they attribute to long-term use of the product and have asserted claims under the insurance policy underwritten and retained by the Company. To date, the number of users reporting such problems is relatively small, and there is presently no conclusive evidence that demonstrates a causal link between long term use of the product and the health problems experienced by the claimants. However, the evidence generated to date indicates that it is at least a reasonably possible that the product is responsible for the problems, the assertion of additional claims is considered probable, and therefore the Company's exposure is material. While an accrual is not warranted, since the loss exposure is not probable and reasonably estimable, the staff believes that disclosures would be required by SFAS 5 because of the "reasonably possible" circumstances.

The disclosure concepts expressed in this example would also apply to an individual claim or group of claims that are related to a single catastrophic event or multiple events having a similar effect.

CHAPTER 9
Controversy Concerning Compilation Services

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Controversy Concerning Compilation Services

This book reviews a variety of current issues in accounting and auditing practice. One of the most controversial is the issue of whether there should be a new level of accounting service below a compilation.

This chapter describes (1) the proposal for service below a compilation, (2) the status of that proposal, and (3) related guidance recently issued by the AICPA's Accounting and Review Services Committee (ARSC).

THE ISSUE

Arguments in Favor of a New Level of Service

Some accountants believe there should be a level of accounting service below a compilation. This might be called the "bring back plain paper" movement. They offer many reasons in support of their position. Some clients need accounting assistance in preparing financial statements on a monthly basis. The level of competence clients needed for this monthly service is not as great as would be required to conform with the compilation standards under SSARS No. 1. Also, current standards usually necessitate that even when financial information is generated in the field, it must be brought to the office for a preissuance review. This makes the information less timely.

The supporters of the proposal state further that the client does not need, and is not willing to incur the expense necessary for determining cost of sales, bad debt expense, and other accounting estimates and allocations on a monthly basis. In particular, CPAs who provide computer processing services to a large volume of clients have significant problems complying with Statements on Standards for Accounting and Review Services (SSARS) No. 1

because it is difficult to scan coding sheets and identify deficiencies in financial statements.

The supporters of the proposal point out that there is a provision for internal-use-only prospective financial statements (see Chapter 3 of this book). Why not bring back internal-use-only historical financial statements? This would help combat the continuing problem of accounting standards overload. Accountants could provide basic information without unnecessary expense. The day-to-day needs of small, private clients do not always require Generally Accepted Accounting Principles (GAAP) financial statements.

Those supporting the proposal do not believe the new level of service will confuse users of the financial statements. They argue that today's users of financial statements understand the accountant's role related to financial statements better than they did when SSARS No. 1 was first issued. No longer is the accountant's involvement in preparation of financial statements assumed when the statements are not accompanied by a CPA's report. Further, compilation and review reports were confusing before the users became accustomed to them. Users will similarly adjust to and understand the level of responsibility associated with legend financial statements.

Arguments Against a New Level of Service

Those opposed to this proposed new service argue that the service would not be professional. Further, there would be an increased risk of litigation because of a greater chance that accountants would be associated with misstated financial statements. Users of financial statements, such as bankers, may be confused about the level of responsibility (or lack thereof) the accountant is assuming.

Those opposed to the proposal are not convinced that the compilation standards are excessive. They point out that current standards allow the omission of footnotes and use of non-GAAP accounting (with disclosure).

The opposition asks, Why are we reexamining this issue? In June 1982, an exposure draft that would have created a level of service below a compilation for computer-prepared interim statements was withdrawn because of strong opposition from practitioners.

THE PROPOSAL

The most recent proposal was put forward by the Technical Issues Committee (TIC) of the Private Companies Practice Section (PCPS). Those in favor of the new level of service refer to it as "legend financial statements."

Legend financial statements would have the following features:

- The accountant would reach an understanding with the client, preferably in writing, that the statements would be restricted to internal use.
- The accountant could have no knowledge of outside use and would cease providing the service if the client circulated the financial statements outside the company.
- Each page of the financial statements would bear the legend, "For management use only—contains departures from generally accepted accounting principles."
- The accountant's name would not appear anywhere in conjunction with the financial statements. There would be no transmittal letter and, other than the legend, the statements would be on plain paper.

THE RESOLUTION

The accounting and review services committee held a public hearing on September 7, 1989, and invited written comments on the issue. After considering the arguments, the committee concluded that there should not be an amendment of SSARS No. 1 to permit a level of service below a compilation. Thus, the performance and reporting standards of SSARS No. 1 continue to apply to annual, quarterly, or monthly financial statements of nonpublic companies whether those statements are prepared manually or using a computer.

NEW GUIDANCE

To clarify certain issues in this area, three Accounting and Review Services (ARSC) Interpretations of AR Section 100 have been issued:

1. Differentiating a Financial Statement from a Trial Balance
2. Submitting Draft Financial Statements
3. Submission of Financial Statements

Financial Statements Versus Trial Balances

Statements on Standards for Accounting and Review Services (SSARS) establish the relevant professional standards when an accountant submits unaudited financial statements of a nonpublic company to the client or others. They do not apply to other accounting services, such as preparing a trial balance. A substantial number of CPAs provide bookkeeping services that involve submitting a trial balance to the client to provide the results of the recordkeeping process. The SSARS No. 1 requirements are what distinguishes the minimum financial statement services provided by a CPA from bookkeeping services.

Could an accountant avoid complying with SSARS No. 1 by calling the financial statements a trial balance? The interpretation identifies the attributes of financial statements and trial balances and indicates that if the financial presentation is in *substance* a financial statement, SSARS No. 1 requirements must be met. What are the characteristics of a financial statement that distinguish it from a trial balance?

The interpretation lists several attributes to consider. Financial statements tend to combine similar general ledger accounts to create classifications or account groupings with subtotals, such as current assets or revenues. Contra accounts tend to be netted with their primary accounts. In contrast, a trial balance lists all the general ledger accounts and their balances.

The title of the financial presentation also helps identify financial statements. For example, a presentation entitled "Balance Sheet," "Statement of Assets and Liabilities," or "Statement of Cash Receipts and Disbursements" would indicate the intention to present a financial statement. A trial balance would typically be titled "Trial Balance" or "Listing of General Ledger Accounts."

A third attribute of financial statements is that they present mathematical relationships among elements. The balance sheet presents—

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

The income statement presents—

$$(\text{Revenues} - \text{Expenses}) + (\text{Gains} - \text{Losses}) = \text{Net Income}$$

A trial balance presents no mathematical relationship other than debits equals credits.

Unlike an income statement, a trial balance does not contain a caption such as "net income" or "net revenue over expenses." Unlike a balance sheet, a trial balance does not present assets in the order of their liquidity and liabilities in the order of their maturity. They are listed in account number order as they appear in the general ledger. Also, in a trial balance, the net results of operations are generally not closed out to retained earnings.

The interpretation makes clear that the accountant must use judgment in determining whether a financial presentation is a trial balance or a financial statement. The existence of one or two financial statement attributes does not preclude the possibility that the presentation is a trial balance. When the presentation is a financial statement, the accountant, at a minimum, should perform a compilation. Alternatively, the accountant may decide to modify the presentation to make it a trial balance. Exhibit 9-1 summarizes the attributes that distinguish a trial balance from financial statements.

Submission of Draft Financial Statements

Some CPAs have in the past prepared interim financial statements and marked them as draft statements, thinking that doing so relieves them of their responsibilities under SSARS No. 1. The new interpretation addresses whether an accountant can submit draft financial statements without intending to comply with the reporting provisions of SSARS No. 1. It states that the accountant should *not* submit draft statements without intending to submit the final financial statements accompanied by a compilation or review report.

The interpretation acknowledges that submission of draft statements, for example, for the client to read and analyze before final issuance, is a common occurrence. In rare circumstances, an accountant issuing draft financial statements may intend to but may unexpectedly not submit the final statements. In this case, the interpretation advises the accountant to document the reasons why he or she was unable to submit the final statements.

Exhibit 9-1 *Financial Statements versus Trial Balances**

Financial Statements	*Trial Balances*
Contain combinations of accounts with subtotals	List all general ledger accounts and their balances
May net contra accounts	Show contra accounts and primary accounts separately
Title: Balance Sheet Statement of Assets and Liabilities Statement of Cash Receipts and Disbursements	Title: Trial Balance Listing of General Ledger Accounts
Present a mathematical relationship such as— Assets = Liabilities + Equity Revenues − Expenses + Gains − Losses = Net Income	Present no mathematical relationship other than— Debits = Credits
Contain a caption such as— "Net Income" or "Net Revenue over expense"	Contain no such caption
Present assets in order of liquidity and liabilities in order of maturity	Present balances in account number order as in the general ledger
Close out net results of operations to retained earnings	Do not close out of income to retained earnings

*Distinguishing a trial balance from a financial statement requires judgment. These attributes are an aid to judgment and not a checklist. The judgment should be based on the preponderance of attributes in the circumstances.

Submission of Financial Statements

This interpretation defines the circumstances in which the accountant is deemed to have submitted financial statements to a client or others, resulting in the requirement that the accountant comply with SSARS No. 1.

The definition is as follows:

> A submission of financial statements is defined as presenting to the client or others financial statements that the accountant has
>
> - generated, either manually or through the use of computer software. Or...
> - modified by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements.

The interpretation provides additional guidance by giving examples of services that do not constitute a submission of financial statements. Such services include reading client-prepared financial statements, proposing correcting journal entries (as long as the accountant does not directly modify the client-prepared statements), preparing standard monthly journal entries, providing the client with a financial statement format that does not include dollar amounts, and advising or providing the client with the use of computer hardware or software that the client will use to generate financial statements.

IMPLEMENTATION ISSUES

The interpretations are effective immediately. They are explanations of existing accounting and review services standards already in effect.

Computerized Financial Information—Case Study

J.W., a CPA, performs monthly services for Amalgamated Associates. Those services consist of coding entries in the cash receipts and cash disbursements journal to reflect the proper general ledge accounts, preparing adjusting journal entries to record depreciation expense and the accrual and deferral of expenses, and performing a monthly bank reconciliation. J.W. enters the coded transactions on the client's in-house computer and processes the data on software that produces the presentation shown in Exhibit 9-2.

Exhibit 9-2

Amalgamated Associates, Inc.

Account Number	Account Description	*December 31, 1990 Balance Sheet* Debit	Credit	*FYE December 31, 1990 Income Statement* Debit	Credit
101	Cash—Checking		10,302.98		
102	Cash—Money Market Savings	17,004.40			
125	Accounts Receivable—Trade	49,550.36			
150	Inventory—Resale	28,234.00			
160	Furniture and Fixtures	10,931.12			
170	Accumulated Depreciation		7,076.00		
180	Loans Receivable	14,000.00			
190	Prepaid Expenses	4,000.00			
200	Accounts Payable		43,407.02		
210	Accrued Expenses		1,227.00		
220	FICA W/H Payable		4,838.98		
230	Federal Income Tax Payable		1,184.00		
240	Non-Current Notes Payable		23,000.00		
250	Current Notes Payable		15,000.00		
300	Capital Stock		36,000.00		
350	Retained Earnings	17,333.85			
400	Sales				448,349.65
430	Interest Income				127.98

500	Purchases			347,865.73	
510	Freight In			2,985.77	
610	Advertising			767.75	
615	Depreciation			3,566.76	
620	Insurance Expense			2,197.88	
625	Salaries—Officers			38,500.00	
630	Salaries—Other			21,614.00	
635	Rent			7,200.00	
640	Interest Expense			3,998.56	
645	Professional Fees			4,785.00	
650	Travel			2,684.00	
655	Meals and Entertainment			233.45	
660	Office Expense			986.61	
665	Payroll Taxes			7,672.82	
670	Utilities			1,409.18	
675	Telephone			2,992.37	
		141,053.73	142,035.98	449,459.88	448,477.63
	Net Loss	982.25			982.25

*This example is adapted from a case prepared by Judith Sherinsky of the staff of the Auditing Standards Division of the AICPA.

The presentation prepared by J.W. purports to be a trial balance, but J.W. has segregated the accounts, labeled the columns "Balance Sheet" and "Income Statement," and indicated the net loss for the year. Does SSARS No. 1 apply to this presentation? Is J.W. required to issue a report?

The accounting services provided by J.W. are reasonably extensive. The applicability of SSARS No. 1 and the requirement to issue a report hinge on whether the trial balance would be considered a financial statement.

The presentation prepared by J.W. does not include notes and most definitions of financial statements include accompanying notes. Is this decisive? No. SSARS No. 1 (AICPA Professional Standards, Vol. 2, AR 100.19) provides for so-called "bob-tailed" statements that omit substantially all disclosures.

One common-sense approach to this dilemma seems to be to consider what happens after J.W. prepares the trial balance. A working trial balance is used to prepare financial statements. Does the company prepare financial statements from the trial balance, or is the schedule prepared by J.W. used in lieu of financial statements? If the presentation is used as a financial statement, an argument could be made that SSARS No. 1 applies and J.W. is required to issue a report and comply with the other performance requirements of SSARS No. 1. The schedule computes a net loss and groups accounts in distinct balance sheet and income statement categories. Those financial statement titles are used.

The interpretation takes the position that a trial balance with classifications and subtotals is the equivalent of a financial statement, and SSARS No. 1 applies. J.W. should attempt to eliminate potential confusion when the intent is only to issue a trial balance and avoid terms normally associated with financial statements. J.W. should not label the difference between revenues and expenses a net loss and should refer to balance sheet *accounts* rather than a balance sheet.

SUMMARY

The ARSC considered a proposal for a level of service below a compilation called legend financial statements. The Committee ultimately voted against it. Accordingly, SSARS No. 1 applies whether the financial statements are annual, quarterly, or monthly, and whether they were prepared by computer or manually. No plain paper or legend statements are permitted.

Several interpretations have been issued to provide guidance in this area:

1. Clarifying the distinction between preparing a trial balance and submitting financial statements
2. Providing guidance to the accountant submitting draft financial statements
3. Defining the circumstances that will be deemed to be "submitting financial statements" requiring performance of a compilation or review

CHAPTER 10
Audit Risk Alerts

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Audit Risk Alerts

The AICPA Auditing Standards Division has developed a type of document to assist auditors—an Audit Risk Alert. The first one issued was a supplement to the December (Vol. 69, No. 19) issue of *The CPA Letter*. Four additional alerts (called "Current Industry Developments") were issued separately (not published in *The CPA Letter*) at the same time. Each addressed a specialized industry. The sixth and seventh alerts were issued in 1990, addressing employee benefit plans industry developments, and state and local governmental developments.

The purpose of an audit risk alert is to alert auditors before year-end to the effects that recent economic, professional, and regulatory developments should have on the planning of audits of financial statements. Such alerts are prepared by most large CPA firms for their audit staffs. The first alert was prepared by the AICPA in consultation with members of the auditing standards board.

This chapter summarizes the content of the general audit risk alert and provides an overview of the six specialized industry alerts.

AUDIT RISK ALERT—YEAR-END 1989

The risk alert has eight sections, each covering a different topic.

Expectation Gap SASs

In the first section, the risk alert reminds the auditor of the expectation-gap Statement on Auditing Standards (SASs), emphasizing that there are new planning requirements, new requirements in performing the audit, and new reporting and communication requirements. The planning requirements discussed include the auditor's responsibility for detecting errors and irregularities that are material to the financial statements, the auditor's responsibility for detecting illegal acts that have a direct and material effect on the financial statements, required analytical procedures in planning the audit, and designing the audit approach based on an assessment of risk. The new performance requirements address the need for a heightened level of professional skepticism: assuming neither management honesty nor dishonesty, the requirement for analytical procedures applied at the overall review stage of the audit, and the requirement to evaluate the going-concern assumption in every audit. The new communication requirements mention the new form of the standard auditor's report; communication of all irregularities and illegal acts, except inconsequential ones, to the client's audit committee; reporting control weaknesses that are considered to be reportable conditions; and required communications with audit committees.

Compliance Auditing

The second topic of the general risk alert concerns the applicability of SAS No. 63 on compliance auditing. The SAS applies to audits of governmental organizations and to some audits of private organizations. For example, it would apply to a trade school if there is a student financial aid provided by the Department of Education. Similarly, it would apply to a construction company when there are Housing and Urban Development (HUD) financial guarantees as well as to a financial institution that processes government guaranteed loans.

The alert points out that some states have adopted the Yellow Book for all audits of their political subdivisions or agencies. Auditors of state agencies should also identify the applicable aspects of SAS No. 63.

Illegal Acts

In discussing the third topic, the general risk alert advises auditors to be sensitive to such matters as environmental issues—for example, Superfund legislation and the responsibility it imposes for cleanup on a client that forecloses on or receives a contribution of land used for hazardous waste.

The alert advises the auditor to use appropriate professional skepticism when a client uses independent contractors, as defined by the IRS. It warns that auditors should consider whether the client may be classifying employees as independent contractors.

The alert also discusses the effects of governmental investigations, such as those that were recently conducted of some defense contractors, and investigations of insider trading. Practices previously accepted by members of an industry may be challenged legally.

Accounting and Reporting Fraud

The fourth topic addressed by the risk alert concerns questionable accounting and fraudulent financial reporting. The alert lists situations that have arisen in recent years which the auditors failed to detect. Might any of these be relevant to your clients? In the area of revenue recognition, the alert mentions, among other things, recording sales under bill-and-hold agreements, recording as sales shipments to third parties authorized to accept goods on behalf of buyers, recording sales with written or oral rights of return when the chance of return is not remote, treatment of operating leases as sales, nonrecording of sales returns, improper application of the percentage of completion method, and undisclosed side agreements on sales. Other improper accounting matters mentioned in the alert include inappropriate deferral of costs, improper off-balance-sheet financing or transactions disguising the substance of transactions, and changing of inventory count sheets.

The alert lists several red flags of possible misstatements, such as unusually heavy sales volume near the end of the year, transactions that seem unnecessarily complex, aggressive growth of a company with a poor internal control structure, and growth in sales or earnings shortly before an initial public offering.

Highly Leveraged Companies and Holders of Junk Bonds

The fifth topic addressed by the general risk alert concerns auditors of highly leveraged companies [including leveraged buyouts (LBOs)] and holders of junk bonds. Auditors of highly leveraged companies should recognize that an economic slowdown may strain the company's liquidity or cause loan violations. The auditor may need to consider the amount and classification of liabilities, going-concern issues, and the entity's plans in light of expected economic conditions.

Auditors of holders of junk bonds should recognize that the market value may depend entirely on the credit-worthiness of the issuer and the holder's ability to keep the bonds until maturity.

Loan Agreements

The sixth risk alert topic points out the following current lending practices: (1) due-on-demand clauses in addition to stated maturity dates, and (2) subjective acceleration clauses that permit acceleration of debt payments based on subjective criteria, such as material adverse changes. Conditions in the economy or in the financial services industry may result in lenders judging these criteria differently than in the past, and lenders may seek to exercise their rights provided by these clauses.

Specialized Industries

The general risk alert addresses two specialized industry categories—financial institutions and pension plans. For financial institutions, the alert points out increased risks in several areas. Downturns of real estate values in some local economies may affect collateral underlying real estate loans and collectibility of the loans. Weak underwriting policies and procedures (particularly over home equity loans) may affect ultimate collectibility. The auditor should be alert for transactions that appear to lack economic substance and should carefully consider the carrying value of securities. The alert also points out that guidance on evaluating the adequacy of allowances for credit losses on loans to less-developed countries is provided in AICPA Auditing Procedure Study No.5, *Auditing the Allowance for Credit Losses of Banks*.

For auditors of pension plans, the alert notes that a recent Department of Labor report disclosed findings that many independent auditors of employee benefit plan financial statements failed to follow the AICPA guide, *Audits of Employee Benefit Plans*, and failed to properly disclose known violations of ERISA regulations. The report also notes that benefit plans' poor internal control structure have led to understatements of employer contributions, improper disbursement of plan assets, and excessive administrative costs.

Recurring Audit Problems

In the eighth section, the alert discusses some problems that have been identified in audits where auditors fell short. One such area is attorney letters. Attorneys' replies may appear to be complete but may actually be vague or ambiguous. Auditing interpretation AU

9337.18 explains what constitutes an acceptable reply. The auditor should also consider whether the reply is dated sufficiently close to the date of the audit report.

A second area of audit problems noted involves audit programs. Written audit programs are required for all audits. They should be adequately tailored for the client's circumstances and for the areas of greater audit risk.

CURRENT ENVIRONMENTS IN SPECIALIZED INDUSTRIES

The AICPA prepared additional alerts, called "Current Industry Developments," for the following specialized industries:

- Savings and loan (S&L) industry developments
- Property and liability insurance industry developments
- Credit union industry developments
- Health care industry developments
- Employee benefit plans industry developments
- State and local governmental developments

Although some variation exists, these alerts are generally divided into four sections: (1) industry and economic developments, (2) regulatory and legislative developments, (3) accounting developments, and (4) auditing developments. The accounting and auditing sections list new professional literature or standards under development that may be useful to the auditor of an entity in the specialized industry. Appendix this chapter lists information to help the auditor obtain additional information or copies of the documents cited.

Savings and Loan (S&L) Industry Developments

An important factor cited in many S&L failures is insider abuse. Red flags indicating insider abuse include loans secured by collateral that has had recent dramatic increases in value; nominee loans; loans with unusual, questionable, or inadequate collateral; out-of-territory loans; and loans that are continuously extended or modified. The alert also lists red flags indicative of increased risk of material error or irregularity: noncompliance with regulatory net worth requirements, significant off-balance-sheet transactions, high rate of growth, significant dependence on brokered deposits, poor loan documentation, significant non-traditional lending or investing activities [e.g., acquisition development and construction (ADC) arrangements], adverse regulatory reports or required regulatory actions, complex parent/subsidiary relationships, significant lending or investment activity inconsistent with management's stated strategy, highly leveraged securities transactions, significant concentrations of loans, and illegal acts.

The alert summarizes the recent regulatory and legislative developments affecting the S&L industry, including the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), and establishment of the Office of Thrift Supervision (OTS) to replace the Federal Home Loan Banks (FHLB). The director of OTS may impose regulatory accounting principles that are more stringent than generally accepted accounting principles (GAAP). The alert discussed the amendment to the Qualified Thrift Lender Test, requiring a higher percentage of S&L assets to be held in qualified investments. Liquidity requirements and capital requirements imposed by FIRREA are explained, together with the implications of lack of compliance.

The alert points out new professional standards and other literature under development that are relevant to S&Ls. These include—

- Consensus decisions of the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force dealing with financial institutions, financial struments, and real estate transactions.
- AICPA Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans,* issued August 1989. (See discussion in Chapter 14.)
- AICPA Savings Institutions Guide (to supersede the 1979 guide), exposed for public comment in September 1990.
- The newly issued Statement of Position (SOP), *Definition of "Substantially the Same" for Holders of Debt Instruments.*
- The proposed SOP, *Inquiries of Representatives of Financial Institutions Regulatory Agencies.*
- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* which requires the auditor to evaluate the entity's ability to continue as a going concern in all audits.

Property and Liability Insurance Industry Developments

This alert points out that there have been rate reductions and slower growth in earned premiums, and it states that many industry analysts believe that this down-cycle will continue in the next year. In 1989, the industry experienced record high levels of catastrophic losses (Hurricane Hugo, San Francisco earthquake, Texas oil refinery explosion, etc.). These losses, together with the decline in premium rates, indicate that the auditor should pay special attention to loss reserve adequacy and reinsurance issues. Also, the auditor should be aware of potential uncertainties in the area of liabilities for environmental or health-related risks, in light of recent court decisions and evolving legal theories. Attention should also be given to regulatory developments such as California Proposition 103, rolling back premium rates. Legislatures in several other states have adopted or are considering similar legislation.

Exhibit 10-1 lists some conditions that affect the property and liability insurance industry's overall audit risk. Exhibit 10-2 lists conditions that may indicate, but not confirm, the existence of increased audit risk for a particular client in the industry.

Exhibit 10-1 ***Overall Risk Factors for the Property and Liability Insurance Industry***

- Historically cyclical underwriting patterns
- Rate and product competition (domestic and international)
- Extensive use of estimates (e.g., loss reserves)
- Social inflation (e.g., increases in litigation or in amounts of jury awards)
- Long-tail nature of business (i.e., lag between occurrence, reporting, and settling of claim)
- Retrospective nature of certain revenue and expense (e.g., workers' compensation)
- Regulatory nature of the industry
- Need for liquidity to pay claims from catastrophes, etc.
- Surplus requirements imposed by regulatory authorities.
- Reliance on third parties, such as agents, loss adjusters, pools, etc., for reporting information used in management and accounting systems
- Impact of the Tax Reform Act of 1986

Exhibit 10-2 ***Specific Conditions or Risk Factors for Property and Liability Insurance Companies***

Condition	*Increased Audit Risk*
Rapid growth in premium volume	Insufficient surplus to support exposure
	Inappropriate pricing or underwriting practices or inadequate loss reserving
	Lack of resources or expertise to administer the new business
	Nontransfer-of-risk reinsurance arrangements
New lines of business	Insufficient experienced or qualified personnel
	Insufficient relevant data by which to establish premium rates or estimate loss reserves
Weak pricing or underwriting practices (deficient policies or failure to observe them)	Acceptance of unanticipated risks or inappropriate pricing of those risks
Lack of expertise by loss reserving personnel, or inadequate, incomplete, or inconsistent historical and current loss-development data	Inappropriate reserving
Weak claims management procedures (deficient policies or failure to observe them)	Excessive or improper claim settlement payments
	Unsound reserving from changes from anticipated claim settlement practices
Lack of an adequate reinsurance program	Concentration of risk geographically or by type of risk, jeopardizing financial stability
Excessive reinsurance coverage	Reduction of margins available to cover fixed and overhead expenses

Exhibit 10-2 *(cont.)*

Condition	*Increased Audit Risk*
Unsound assuming company or disagreements over contract terms	Uncollectible reinsurance
Assuming reinsurance only occasionally	Insufficient established policies and procedures, inexperienced personnel, or delays in receiving information resulting in lack of supporting information needed for reporting and administration
Fronting	Large potential liabilities for the fronting company if fronted company does not meet its obligations
Speculative or high-yield investments	Need to liquidate long-term investments at a loss for cash flow needs
	Risk in valuation of the investments if not readily marketable
Delegation of significant operational authority to outside parties	Risk of lack of procedures to supervise, control, and monitor outside parties

An exposure draft of a proposed SOP has been issued, entitled *Reporting by Financial Institutions of Debt Securities Held as Assets*, and will affect property and liability insurance companies. This proposed SOP is discussed further in Chapter 14.

Several statutory accounting developments are noted in the alert, including the penalty for overdue reinsurance, new guidance on accounting for transfers between affiliates in the National Association of Insurance Commissioners' accounting manuals, and the prohibition of reporting of surplus generated from sales of future revenues unless complying with GAAP and approved. Also, the SEC has issued a Staff Accounting Bulletin requiring disclosure of reserve ranges in accordance with Financial Accounting Standards Board Statement (SFAS) 5 for certain situations.

Credit Union Industry Developments

One trend that auditors of credit unions should be alert to is that credit unions are now making more of their loans through fixed rate mortgages, second lien mortgages, and other real estate loans. This expansion requires additional management expertise and an improved internal control structure, including an effective supervisory committee. Auditors may wish to consider that lack of supervisory committee involvement in credit union operations may be an early indicator of potential problems. Auditors should also be aware that instances have been noted in which credit union loans have been rolled over and removed from the delinquent listing, resulting in erroneous loan loss evaluation.

In the area of regulatory and legislative developments, FIRREA has provisions that affect credit unions as well as S&Ls. As a result of FIRREA, the National Credit Union Administration (NCUA) prescribed auditing standards requiring any federally insured credit union to have certain agreed-upon procedures performed by an independent CPA for any fiscal year in which (1) the credit union has not conducted an annual supervisory committee audit, or (2) the supervisory committee audit was not complete and satisfactory. An audit by an independent CPA is required if the credit union has persistent and serious recordkeeping deficiencies. FIRREA also requires credit unions to provide to their auditor with the most recent report of examination and other correspondence between regulators and the credit union.

New professional standards or other professional literature under development that the auditor of credit unions should be aware of include—

- FASB Emerging Issues Task Force (EITF), Issue 89-3, indicating that credit unions must unequivocally present members' share accounts (also referred to as savings accounts) as a liability on the balance sheet. Classification of all liabilities and equity under one caption, with no distinction between the two, is not in accordance with the AICPA Audit Guide *Audits of Credit Unions*. (The NCUA classifies members' share accounts as equity.)
- An amendment to SFAS 95 that would permit credit unions to net certain cash receipts and cash payments.

- SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which is highlighted in the alert because it has been difficult for some credit unions to implement (if they do not have the resources to distinguish properly between loan origination costs and other administrative costs).
- SFAS 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk.*
- The audit and accounting guide, *Audits of Credit Unions*, which is being updated. An area currently under consideration is whether investments in debt securities should be accounted for at cost, marked to market value, or recorded at the lower of cost or market.
- The newly revised NCUA *Accounting Manual.*
- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, SAS No. 57, *Auditing Accounting Estimates* (particularly as it relates to evaluating the allowance for loan losses), and SAS No. 61, *Communication with Audit Committees* (providing guidance on matters to be communicated to the supervisory committee on all audit engagements).

Health Care Industry Developments

Empty hospital beds, reductions in Medicare and Medicaid funding, increases in health care costs, medical malpractice losses, nursing shortages leading to higher costs, losses on risk contracts, lower contracted payment rates with insurance companies, and cost increases for services to indigent patients have resulted in significant financial problems in the health care industry. Accordingly, auditors should be alert to the possibility that some health care providers may not be in compliance with debt-covenant restrictions and may need to seek alternative financing or file for bankruptcy.

Other industry developments that auditors should be aware of include the trend in the Health Maintenance Organization (HMO) industry to consolidate small plans with larger plans, the financial difficulties of some property and liability insurance companies (when they are third party payors on accounts receivable or under-write malpractice coverage), and antikickback provisions of the Social Security Act (which prohibit remuneration to any person for referring a patient).

The Health Care Financial Management Association annually prepares the *Hospital Industry Financial Report*, summarizing trends in the health care industry. Copies can be obtained from the address given in the appendix to this chapter.

Regulatory and legislative developments affecting the health care industry include a law requiring change in the Medicare reimbursement mechanism for capital-related items to a prospective-type system. However, the form of the changes and their effects are not specified in the law and are not yet known. Accordingly, uncertainty exists about whether deferred reimbursement asset accounts associated with capital-related costs will be realized cash and whether deferred reimbursement liability accounts associated with such costs must be repaid by the hospital.

Professional standards that are new or currently under development of significance to the health care industry include—

- AICPA SOP 87-1, *Accounting for Asserted and Unasserted Medical Malpractice Claims of Health Care Providers and Related Issues*.
- AICPA SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*.
- An exposure draft of a proposed AICPA Audit and Accounting Guide, *Audits of Providers of Health Care Services*, which will supersede the 1972 *Hospital Audit Guide* and will address not only hospitals, but also nursing homes, HMOs, continuing care retirement communities, physician group practices that issue financial statements in accordance with GAAP, and ambulatory care facilities.
- An exposure draft of a proposed AICPA SOP, *Accounting and Reporting by Continuing Care Retirement Communities*.
- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, because of the financial difficulties being experienced by some health care providers.
- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and SAS No. 54, *Illegal Acts by Clients* (because of the complexities of current Medicare and Medicaid programs and physician kickback provisions).

Employee Benefit Plans Industry Developments

According to the 1989 Department of Labor report, *Trends in Pensions*, U.S. employee benefit plans have approximately $2 trillion in assets. Most plans hold assets in excess of termination liabilities, with underfunding concentrated in a few plans. However, there is a concern that some pension investments have been too risky (e.g., purchasing junk bonds, underwriting leveraged buyouts, purchasing real estate), and the weakening economy could have an unfavorable impact on plan assets.

The IRS and Department of Labor (DOL) are now reviewing Form 5500 plan annual report filings more extensively, and there are new civil sanctions for filing deficiencies that are not promptly resolved. Reporting of realized and unrealized gains and losses on investments changed with the 1988 Form 5500, which required that realized and unrealized investment gains and losses be determined separately based on revalued cost (i.e., current value at the beginning of the plan year). Failure to do this in 1988 and 1989 would not cause the DOL to reject the filing; however, for plan years beginning on or after January 1, 1990, plan administrators must report using revalued cost.

Professional standards that are new or currently under development of significance to the employee benefit plans industry include—

- FASB's EITF Issue 89-1, regarding financial statement valuation of guaranteed investment contracts and similar instruments.
- SFAS 102, *Statement of Cash Flow—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, which provides an exemption from presenting a statement of cash flows for certain employee benefit plans.
- SFAS 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, which requires disclosures about financial instruments with off-balance-sheet risk and significant concentrations of credit risk.
- Revision of the 1983 AICPA audit and accounting guide, *Audit of Employee Benefit Plans*. An exposure draft is expected to be issued in late 1990.
- AICPA Statement of Position 88-2, *Illustrative Auditor's Reports*

on Financial Statements of Employee Benefit Plans Comporting with Statement on Auditing Standards No. 58, Reports on Audited Financial Statements.

- Department of Labor 401(k) Plan audit requirements. The number of employees eligible to participate in a 401(k) plan and those participating should both be considered for purposes of determining the requirement for an audit. Audits are generally required for plans with more than one hundred participants as of the beginning of the plan year.
- Department of Labor rules and regulations for reporting and disclosure under ERISA section 2520.103-8, permitting limited-scope audit procedures with respect to information prepared and certified by a bank or similar institutions, or by an insurance carrier that is regulated, supervised, and subject to periodic examination by state or federal agency.
- SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, which applies to certain supplemental schedules required by ERISA.
- SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.* In a full-scope audit of a plan with a discretionary trust arrangement, the SAS requires the auditor to obtain an understanding of the trustee's internal control structure to plan the audit. If the auditor decides to assess control risk at less than the maximum for particular assertions, the auditor will need to obtain evidence of the operating effectiveness of those policies and procedures. The auditor may obtain this evidence by obtaining a service auditor's report or by visiting the trustee to perform appropriate tests.
- SAS No. 57, *Auditing Accounting Estimates,* may be important in evaluating eligibility credits and accrued experience rating adjustments in audits of health and welfare plans.
- U.S. DOL office of the Inspector General report, *Changes Are Needed in the ERISA Audit Process to Increase Protection for Employee Benefit Plan Participants,* which included the results of a review of 279 randomly chosen plan audits. The report concludes that the auditors did not consistently comply with generally accepted auditing standards and reminds the auditor of the audit guide's recommended procedures. It also provides a list of required disclosures that the auditor should keep in

mind when reviewing the financial statements, supplemental schedules, and notes.

State and Local Governmental Developments

Change is a key element of the current governmental accounting and auditing sector. The Governmental Accounting Standards Board (GASB), AICPA, U.S. General Accounting Office (GAO), the U.S. Office of Management and Budget (OMB), and the President's Council on Integrity and Efficiency (PCIE) all have been and are continuing to issue new guidance relating to governmental entities. In addition, many governments themselves have adopted legislation on financial accountability and internal controls. The legislation addresses such topics as travel and entertainment expenses, use of discretionary funds, conflicts of interest and ethics, private use of publicly owned property, outside political activities, lobbying, and disclosure requirements for recipients of federal funds. In this politically sensitive environment, the auditor needs to be aware of the new authoritative guidance and to be alert to the potential impact of mismanagement, defalcations, and noncompliance with laws and regulations.

The GASB

The Financial Accounting Foundation recently reaffirmed that the GASB will retain jurisdiction over all governmental entities (including special entities, such as public colleges and health care facilities). Compliance with FASB statements and interpretations will not be mandatory for governmental entities unless the GASB specifically designates them as applicable.

The GASB is reexamining the basic concepts underlying governmental accounting and financial reporting. They have issued GASB Statement No. 11, *Measurement Focus and Basis of Accounting–Governmental Fund Operating Statements*, which is effective for financial statements for periods beginning after June 15, 1994. The GASB delayed the effective date to allow themselves time to develop, expose and issue the additional standards needed to implement the focus described in GASB Statement No. 11. The statement prescribes the flow of financial resources measurement focus for governmental fund operating statements. It provides guidance for balance sheet reporting of only general long-term capital debt. Guidance for balance sheet reporting of other liabilities arising from or related to the operations of governmental funds will be provided in future statements.

GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, requires a statement of cash flows instead of a statement of changes in financial position in the financial statements of applicable entities. It requires classification of receipts and payments by category (e.g., investing, capital, and financing activities). The statement is effective for annual financial statements for fiscal years beginning after December 15, 1989.

GASB Statement No. 10, *Accouting and Financial Reporting for Risk Financing and Related Insurance Issues*, establishes accounting and financial reporting standards for risk financing and insurance-related activities of state and local governmental entities. The requirements for public entity risk pools are effective for financial statements for periods beginning after June 15, 1990. For other entities, the effective date is for periods beginning after June 15, 1994.

GASB Statement No. 12, *Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers*, requires such employers to make a variety of disclosures such as a description of benefits provided and who is covered. The statement is effective for fiscal years beginning after June 15, 1990. (The alert also lists accounting and reporting factors for government pension plans and deferred compensation plans.)

GASB Statement No. 13, *Accounting for Operating Leases With Scheduled Rent Increases*, requires governmental entities to account for such leases by using the terms of the lease contract when the pattern of payment requirements is systematic and rational. The statement is effective for leases with terms beginning after June 30, 1990.

The GAO, Single Audit Act, and Related Professional Standards

Nonfederal auditors are required to follow the standards set forth in *Government Auditing Standards—1988 revision* (the Yellow Book). Among other things, the Yellow Book requires auditors responsible for government audits to complete eighty hours of continuing professional education (CPE) every two years, with at least twenty hours to be completed each year. Of the eighty, at least twenty-four hours should be in subjects directly related to the government environment and government auditing. The CPE requirements must be met by auditors who perform audits in accordance with the Yellow Book after January 1, 1989. The requirements must be fulfilled by January 1, 1991. The Yellow Book also requires audit organizations to establish an internal quality control system and participate in an external quality control review at lease once every three years. The peer review requirements applies to audit organizations performing audits after January 1, 1989, and a review must be completed by January 1, 1992.

In addition to the Yellow Book requirements, the Single Audit Act of 1984 requires each state and local government that receives a total amount of federal financial assistance equal to or in excess of $100,000 in any fiscal year to have an audit made for that year in accordance with its requirements. Governments that provide federal grant funds to other organizations through a subgrant relationship are required to ensure that the subrecipient organization complies with the applicable federal audit requirements.

The AICPA's SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*, provides standards for auditors that are testing and reporting on compliance with laws and regulations in audits in accordance with generally accepted auditing standards, the Yellow Book, and the Single Audit Act of 1984, as well as on reporting on internal control in accordance with the Yellow Book.

The President's Council on Integrity and Efficiency (PCIE)

The Standards Subcommittee of the PCIE recently issued a report on the quality of nonfederal audits reviewed by Federal Inspectors General. The Inspectors General found significant reporting and auditing deficiencies that made the audit reports unsuitable for their purposes. Deficiencies included missing reports on internal controls; missing reports on compliance with laws and regulations; missing financial statements, footnotes, and supplementary data; inadequate work paper documentation of the procedures performed; and deficient report language.

The PCIE Standards Subcommittee publishes supplemental nonauthoritative guidance for federal officials dealing with issues arising from the implementation of the Single Audit Act (see the appendix to this chapter).

The OMB

OMB Circular A-128, *Audits of State and Local Governments*, implements the Single Audit Act. OMB Circular A-33, *Audits of Institutions of Higher Education and Other Nonprofit Organizations*, extends the single-audit concept to nonprofit organizations receiving federal funding. In addition, the OMB recently issued a list of major federal grant programs that have a higher risk of fraud and abuse (Exhibit 10-3). It also listed conditions that, when present, cause a federal program to be at higher risk of fraud and abuse (Exhibit 10-4).

Exhibit 10-3 ***Higher Risk Federal Programs***

- The Food Stamp Program
- Job Training Partnership Act programs
- Mass transit grants
- The Environmental Protection Agency Superfund program

Exhibit 10-4 ***Conditions Listed by the OMB That Indicate a Higher Risk of Fraud, Waste, and Abuse for Federal Programs***

- Large numbers of transactions and cash flows
- Broad, inadequately supervised delegation of authority
- Excessively decentralized program execution
- Potential for physical or environmental damage
- Recent start-up or pending termination
- Inadequate attention to management by political leadership

Other Topics

The alert also discusses errors, irregularities and illegal acts; investments and investing activities in accordance with GASB Statement No. 3; revenue bond defaults, lease and rental arrangements with public authorities; self-insurance arrangements and incurred-but-not-reported claims; and a variety of reporting issues for governmental entities and affected nonprofit organizations.

IMPLEMENTATION ISSUES

Status of Audit Risk Alert Series

What are audit risk alerts and current industry developments, and why are they being issued? Audit risk alerts are prepared by the AICPA staff in consultation with the relevant technical committees and members of the Auditing Standards Board. However, the alerts are not approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

They are issued to notify auditors about developments in the economy, industry, and profession, including new standards, laws, and regulations that may be useful to an auditor in audit planning. Audit risk alerts present issues of common interest to many auditors. Current industry developments are issued to assist auditors with an interest in a specialized industry.

SAS 22 (AU 311.07) describes the knowledge the auditor should obtain about the client's business. It states, "The auditor should also consider matters affecting the industry in which the entity operates, such as economic conditions, government regulations, and changes in technology, as they relate to his audit." An audit risk alert or current industry developments document is one source for some of this information.

Notification of Issuance of Audit Risk Alerts or Current Industry Developments

Currently, audit risk alerts of general interest are mailed to members as a supplement to *The CPA Letter*. *The CPA Letter* also contains an announcement of any new current industry developments that are issued, together with information needed to order copies.

Ordering Audit Risk Alerts and Current Industry Developments

Copies of *Audit Risk Alert—1989* (product number 022050) are available from the AICPA order department at $2.00 each, $1.60 to members.

Savings and Loan Industry Developments—1989 (product number 022051), *Credit Union Industry Developments—1989* (product number 022053), *Property and Liability Insurance Industry Develop-*

ments—1989 (product number 022054), *Health Care Industry Developments—1989* (product number 022052), *Employee Benefit Plans Industry Developments—1990* (product number 022055), and *State and Local Governmental Developments—1990* (product number 022056) are available from the AICPA order department at $2.50 each, $2.00 to members. See the appendix to this chapter for the address and phone number of the order department.

Timing of Audit Risk Alerts and Current Industry Developments

Audit Risk Alert—1989 was published in the December 1989 issue of *The CPA Letter*, which also announced four current industry developments. Why should an auditor order a 1989 alert in 1990? Is the information outdated?

Audit Risk Alert—1989 was issued in December 1989 to help auditors plan their audits of fiscal years beginning in 1989. Like any form of news, additional events may occur after its issuance. However, notification about such events as regulations passed and their potential effects on an audit in a particular industry, and relevant new professional standards issued, are valuable assistance to auditors. The alerts also point out audit guides and other professional literature that is currently being revised, so that the auditor has some warning and can look for the new document. Notification also provides an opportunity for auditors with clients in the industries affected to order an exposure draft and provide input to the standards before they are issued.

Audit risk alerts and current industry developments are issued not only at year-end, but as soon as they can be developed when the need for an alert on the topic is determined.

Audit Risk Alert Case Study

This case study involves a company in the extraction industry and takes place several years in the future.* National Mining is a silver mining company located in a western state. Its principal product, silver, is taken from a mine in nearby mountains. During the audit, JW, CPA, made an on-site tour through numerous tunnels located

*This case study is adapted from a case prepared by Glen Davison of the staff of the Office of the Chief Accountant of the SEC.

approximately five miles underneath the mine entrance. During this tour, JW noted that large water pumps were used to pump water from the mine tunnels. Astutely, JW asked the controller where the water goes, and he indicated that the drainage is to a large holding pond below the mountain. The pond is stocked with large trout in accordance with EPA requirements. Being an avid fisherman, JW asked permission to fish on his lunch hour, but the controller would not let him go fishing because the fish are used to determine if there is any water contamination. That is, if the water is contaminated, it is expected the contamination will have an adverse effect on the trout.

On a sunny Monday, the day before JW is expected to issue the audit report, the controller informed him that the mine manager reported the fish were floating belly-up in the pond that morning. JW expresses concern because he has recently read an audit risk alert (*Current Extraction Industry Developments—1996*) about actions taken by the EPA where environmental contamination has occurred.

What effect should the dead fish have on JW's audit and reporting responsibilities? What, if any, implications should the federal regulations resulting in the fish pond have on audit planning and the audit program?

The audit risk alert explained the potential effects (fines, responsibility for clean-up, and in some cases potential criminal liability for such contamination). It cited the relevant regulations so JW can obtain more detailed information. The audit alert also reminded the auditor to consider SAS No. 54 on illegal acts.

SAS No. 54 (AU 317.10) states: "When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements." The auditor might consult with the client's legal counsel or other specialists and, perhaps, apply additional procedures.

The dead fish constitute specific information concerning possible illegal acts, and the auditor would need to apply specific procedures directed to determining whether an illegal act has occurred and to evaluate the need for disclosure. Presumably, at this point, there is an unasserted claim and the auditor would need to apply the criteria of SFAS 5 on loss contingencies to consider disclosure requirements.

A more complex issue is what effect the federal regulations and fish pond should have had on planning the audit, in the absence of the dead fish (i.e., if the fish had continued living). SAS No. 54 (AU

317.08) states: "The auditor should make inquiries of management concerning the client's compliance with laws and regulations."

An auditor of a company in the extraction industry should recognize the significance of compliance with the environmental protection laws and regulations and make specific inquiries concerning the client's compliance. As noted in the case study's *Current Extraction Industry Developments,* consideration of the adequacy of the client's policies and procedures for monitoring compliance should be part of the auditor's control risk assessment. The assessment of risk in the circumstances will determine the scope of audit procedures considered necessary.

SUMMARY

Audit Risk Alerts and *Current Industry Developments* are new types of publications developed by the AICPA Auditing Standards Division to assist auditors. A general audit risk alert was published in the December 1989 issue of *The CPA Letter*, and six additional alerts have been issued addressing specialized industries. The new publications help auditors in planning by explaining economic, professional, and regulatory developments that may affect their clients.

APPENDIX

Sources of Further Information

To order Audit Risk Alerts, Current Industry Developments, Statements on Auditing Standards, Statements of Position, and other AICPA publications:

Order Department
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036
(800) 334-6961 (US)
(800) 248-0445 (NY)

To order FASB Statements, Issues of the Emerging Issues Task Force, and other FASB publications:

Order Department
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
(203) 847-0700

To order authoritative literature and other publications of the Governmental Accounting Standards Board (GASB):

Order Department
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
(203) 847-0700

Answers to inquiries about specific audit or accounting problems:

AICPA Technical Information Service
(800) 223-4158 (Except New York)
(800) 522-5430 (New York Only)

Copies of the HFMA *Hospital Industry Financial Report*:

Health Care Financial Management Association
Order Department
2 Westbrook Corporate Center
Suite 700
Westchester, IL 60154
(800) 252-4362 or (312) 531-9600

Copies of the Department of Labor's *Trouble-Shooters' Guide to Filing the ERISA Annual Reports*:

Chief, Division of Public Information
U.S. Department of Labor
Room N-5511
200 Constitution Avenue, N.W.
Washington, DC 20210

Copies of the Single Audit Information Service:

Thompson Publishing Group
(202) 872-1766

Copies of *Audits of State and Local Governments*, *Audits of Small Businesses*, and other publications:

Practitioners Publishing Company
(800) 323-8724

Copies of *Government Auditing Standards* (Yellow Book—1988 Revision), HUD audit guides, and the *Catalog of Federal Domestic Assistance*:

Government Printing Office (GPO)
Superintendent of Documents
Washington, D.C. 20401

Copies of *Audit Guide–Audits of Student Financial Assistance Programs*:

Office of the Inspector General
U.S. Department of Education
Washington, D.C.

Copies of *Assessing Compliance With Applicable Laws and Regulations*:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Copies of OMB Circulars relevant to audits of state and local governments:

Executive Office of the President
Publications Office
(202) 395-7332

To order publications of the Government Finance Officers Association:

Government Finance Officers Association
180 N. Michigan Avenue
Suite 800
Chicago, IL 60601-7476
(312) 977-9700

Copies of PCIE Standards Subcommittee Position Statements:

U.S. Department of Education
Office of Inspector General
(202) 732-4798

CHAPTER 11
Getting Ready for Quality Review

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Getting Ready for Quality Review

In January 1988, the AICPA membership approved a plan to restructure professional standards. This restructuring included a new Code of Professional Conduct, a 150-hour education requirement, and a practice-monitoring requirement. This chapter focuses on the practice-monitoring requirement. It explains the key features of the AICPA quality review program including entities that may administer the review, types of quality reviews, and the sources and qualifications of reviewers. It describes how to prepare for a quality review of a firm's accounting and auditing practice. The newly issued interpretation addressing reviews of sole practitioners with no professional staff is explained. The chapter also describes common peer reviewer comments from prior reviews.

INTRODUCTION

All AICPA members who are engaged in the practice of public accounting are now required to be practicing in a CPA firm enrolled in an approved practice-monitoring program. A CPA firm, for this purpose, includes a sole proprietorship (with or without professional staff), a partnership, or a professional corporation. There are only two approved practice-monitoring programs, and both of them are administered by the AICPA. One of these programs is the AICPA Division for CPA Firms. The other is the AICPA quality review program. The AICPA quality review program provides for participation by state societies of CPAs and associations of CPA firms. This chapter explains only the quality review program.

THE PRACTICE MONITORING REQUIREMENT

Who Must Enroll?

AICPA members who are engaged in the practice of public accounting are required to be practicing as proprietors, partners, shareholders, or employees of firms enrolled in an *approved practice-monitoring program*. Every CPA firm that is not a member of the AICPA Division for CPA Firms should be enrolled in the AICPA quality review program, regardless of whether the firm has an accounting or auditing practice. To do this the CPA should submit a Quality Review Program Enrollment Form to:

AICPA
Quality Review Division
1211 Avenue of the Americas
New York, NY 10036

The initial enrollment date was July 12, 1988, for firms and January 12, 1990, for employees of CPA firms.

At least one of the proprietors, partners, or shareholders of a firm that seeks to be enrolled in the AICPA quality review program must be a member of the AICPA.

When Must There Be a Review?

An enrolled firm must have a quality review in accordance with the Standards for Performing and Reporting on Quality Reviews once every three years if it performs accounting or auditing engagements.

The nature and size of a CPA firm's practice determine the type and timing of the review. Firms without auditing or accounting clients will not be reviewed. (If such a firm accepts an accounting or auditing client, it will be expected to have a review within approximately eighteen months.)

Firms with an audit practice will have an on-site review; firms that perform compilations or reviews of financial statements but no audits will have an off-site review. The timetable for initial reviews is presented in Exhibit 11-1. There is one exception to the timetable. A firm with government or nonprofit clients who are required to have

Exhibit 11-1 *Timing of Reviews*

The initial reviews under the program will be phased in based on the size of a firm and the nature of its practice in accordance with the following schedule:

	1989	*1990*	*1991*	*1992*	*1993*
Sole practitioners					
Without audits				X	X
With audits			X	X	
Two to ten professionals					
Without audits			X	X	
With audits		X	X	X	
Over ten professionals					
Without audits		X			
With audits	X	X			

an audit in accordance with the Yellow Book must be reviewed by January 1, 1992.

The AICPA Quality Review Division will notify firms of the specific timing of their reviews. Questions about the due date for reviews will be answered by the Division at (212) 575–6650.

There is a limited degree of flexibility in the timing of reviews. A firm that believes it cannot have its quality review start on the assigned date may submit a letter to the administrator of the review at least sixty days prior to the due date explaining why the review should be postponed and offer alternative dates.

Other Requirements

A firm may not resign from the program during a review. A resignation during a review will be considered evidence of a failure to cooperate and could lead to sanctions against the firm.

A firm is not required to have a quality control document that describes its system for control of its accounting and auditing practice. However, completion of a quality control questionnaire on those policies and procedures is required. (See the appendix to this chapter.)

THE QUALITY REVIEW PROGRAM

Who Administers the Review?

The entity administering the review will be either the AICPA Quality Review Division or a state CPA society that has elected to participate. Associations of CPA firms may assist their members in arranging and carrying out on-site reviews, but are not authorized to arrange or carry out off-site quality reviews. Positive enforcement programs of state boards of accountancy do not qualify as quality reviews, and compliance with such a program does not meet the AICPA practice-monitoring requirement.

Who Performs the Review?

A quality review may be performed by a committee-appointed review team (CART), a firm (a team formed by a CPA firm engaged by the firm under review), or an association team (a team formed by an association of CPA firms). A review starts when the CPA firm under review signs and returns an engagement letter to the entity forming the review team.

So far, most CPA firms have decided to have a review by a CART.

Qualifications and Sources of Reviewers

An individual serving as a reviewer (on-site or off-site review) must be a member of the AICPA, licensed to practice as a CPA, and possess current knowledge of applicable professional standards. For an on-site review team, the following additional requirements apply:

- All team members must have at least five years experience in the practice of public accounting in the accounting and auditing function.
- A team captain must be a proprietor, partner, or shareholder of an enrolled firm and have completed a training course. After January 1, 1992, the team captain must also be associated with a firm that has received an unqualified report on its system of quality control within the previous three years.

Enrolled firms will be requested periodically to indicate whether the firm would accept engagements to perform quality reviews or whether the firm would nominate individuals for service as reviewers. (Participation as a reviewer or reviewing firm is voluntary.) Application forms to serve as a reviewer are available from the AICPA quality review division and participating state societies.

SPECIFIC STEPS TO PREPARE FOR A REVIEW

Sources of Information

A variety of materials and sources are available to help a firm prepare for a review. The AICPA and some state societies have developed continuing professional education courses on quality reviews. The AICPA has the following publications to provide assistance:

- The AICPA *Quality Review Program Manual.* (See Exhibit 11-2.)
- TIPS (technical information for practitioners series) 4, "Implementing Quality Control: Forms and Sample Documents." (See Exhibit 11-3.)

Both the QRP Manual and TIPS 4 are useful sources of information. The QRP Manual is for CPA firms to be reviewed, reviewers and reviewing firms, associations of CPA firms, and the AICPA quality review division itself. TIPS 4 is directed specifically to the CPA firm to be reviewed.

Exhibit 11-2 ***AICPA Quality Review Program (QRP) Manual***

Section	***Title***
1000	Introduction
2000	Information About the Administration of the Quality Review Program
3000	Standards for Performing and Reporting on Quality Reviews
4000	On-Site Quality Reviews for Firms that Perform Audits
5000	On-Site Review Engagement Checklists
6000	Summaries of On-Site Review Engagement Findings
7000	Off-Site Quality Reviews for Firms that Perform No Audits
8000	Guidelines for Involvement of Associations of CPA Firms in the Quality Review Program

Exhibit 11-3 ***TIPS 4***
Implementing Quality Control: Forms and Sample Documents

Section	*Title*
11,100	Quality Control—General
11,200	Sample Quality Control Document for a Two-Partner Local CPA Firm
11,300	Sample Quality Control Document for a Four-Partner Local CPA Firm
11,400	Sample Quality Control Document for a Sole Practitioner CPA Firm Without Full-Time Staff
11,500	Sample Quality Control Document for a Sole Practitioner CPA Firm with Full-Time Staff
11,600	Sample Quality Control Forms (Engagement Letters, Client Acceptance Forms, Planning Checklist, Audit Time Budget, etc.)

Several CPA firms experienced in performing quality reviews are offering consulting reviews. The results of the review are communicated only to the reviewed firm.

Advance Preparation for a Review

Advance preparation is very important to—

- Get the most out of a quality review.
- Avoid unnecessary costs.
- Avoid a qualified review report.

As advance preparation for a quality review, a CPA firm should first consider the importance of the firm's accounting and auditing practice. If a firm's practice includes very little accounting and auditing, it may be more efficient to abandon that area of its practice. Then the CPA should gather the firm's written policies and procedures relevant to quality control, standardized forms and checklists, and other generalized materials. The next step is to complete a quality control policies and procedures questionnaire. (See the appendix to this chapter.)

Another valuable step is to conduct an internal inspection program or engage a firm for a consulting review to evaluate the firm's compliance with firm policies and procedures and professional standards. Based on the results of the review, firm management should consider whether any existing policies and procedures should be modified. Firm management should also consider whether to develop the necessary written quality control materials or purchase them from a commercial vendor and whether to prepare a quality control document that describes the firm's quality control policies and procedures.

Keep in mind that the reviewer will, among other things, inspect the firm's library, test continuing professional education (CPE) records, and check for annual independence representations in addition to reviewing selected engagements and workpapers.

Chronology of Participation

Exhibit 11-4 lists each significant step in the quality review process from beginning to end. It describes the chronology of the participation of a CPA firm with an audit practice in the quality review program. Some matters may alter the chronology, however. For example, a reviewed firm may have legitimate reasons for not permitting the review of working papers for certain engagements. These reasons may include objections from the client or the knowledge that the engagement may be the subject of litigation or government investigation. (The review team must be satisfied with the reasonableness of the explanation and consider whether it represents a significant scope limitation.)

Exhibit 11-4 ***Chronology of Participation in the Quality Review Program by a Firm with an Audit Practice***

- Submit enrollment form to AICPA Quality Review Division.
- Receive notification from the Division of due date for review.
- Select source of review team—CART, CPA firm, or association.
- Sign engagement letter and return it to the entity forming the review team.
- Complete questionnaire on quality control policies and procedures and prepare lists of accounting and auditing engagements and firm professional personnel for the review team's use.
- Consider the review team captain's preliminary advance selection of engagements for review and designate those that may appropriately be excluded.

Exhibit 11-4 *(cont.)*

- Assemble material that the review team will request including representations of professional personnel on independence; personnel files; CPE records; all working papers, files, and reports for engagements selected.
- Make documentation and firm personnel available to reviewers as requested.
- Respond to Matter for Further Consideration (MFC) forms.
- Attend exit conference.
- Receive review report and letter of comments, if any, from the team captain and prepare response.
- Submit a copy of the report, letter of comments, and the firm's response to the entity administering the review.
- Receive notification from the entity administering the review of formal acceptance of the review as meeting the requirements of the quality review program.
- If the firm so chooses, make the results of the review available to the public.

Results of the Review

At the end of the engagement, an exit conference is held and the reviewer's findings are discussed. A written report, which may be unqualified or modified, is issued.

A (MFC matters for further consideration) form is completed by the review team for all significant matters, including potential departures from professional standards, noncompliance with the reviewed firm's policies or procedures, deficiencies in audit documentation, and serious weaknesses in the design of quality control policies and procedures.

A letter of comments is required when there are (1) matters that resulted in modifications to the standard report or (2) matters that the review team believes resulted in conditions being created in which there was more than a remote possibility that the firm would not conform with professional standards on accounting and auditing engagements. Letters of comments are normal for most on-site reviews—a firm should expect one. No reference to the letter of comments is made in an unqualified review report.

The firm writes a response to the report and letter of comments, indicating plans to correct the matters cited.

Costs of Participation

Entities administering quality reviews (the AICPA or participating state societies) are authorized to establish dues or registration fees to fund the administration of the program, and establish rates at which reviewers on committee-appointed review teams will be paid. Associations of CPA firms and CPA firms that perform reviews may set their own rates. Exhibit 11-5 summarizes the costs of peer reviews conducted during the 1989 review year.

REVIEWS OF SOLE PRACTITIONERS WITH NO PROFESSIONAL STAFF

In May 1990, an interpretation of the standards for performing and reporting on quality reviews was issued. It is applicable to certain sole practitioners.

The standards require an on-site quality review for a firm with an audit practice. However, many sole practitioners believe that their reviews would be more cost-effective if they were permitted to bring the required files, reports, and other evidential matter to the reviewer. The interpretation permits the review to be conducted at the reviewer's office or another agreed-upon location if the following qualifications are met:

- The firm consists of a sole practitioner with no professional staff.
- The sole practitioner does not employ or engage other individuals to participate in the conduct of audits.
- The sole practitioner meets personally with the reviewer to discuss the practitioner's responses to the questions in the "Quality Control Policies and Procedures Questionnaire for Sole Practitioners with No Professional Staff" and to discuss the reviewer's conclusions on the review.
- In addition to materials outlined in the "Instructions to Firms Having an On-Site Quality Review" (QRP section 4100.07), the sole practitioner sends the material listed in Exhibit 11-6 to the reviewer before the review.

Exhibit 11-5 ***Peer Reviews Conducted by PCPS Committee-Appointed Review Teams***
Cost Summary—1989 Review Year

Firm Description	*Number of Firms*	*Average Number of Professionals*	*Cost per Review* Low	*Cost per Review* Average	*Cost per Review* High	*Average Cost per Review—1988*
Sole practitioner, no professional staff	4	1	$1,237	$2,200	$ 2,898	$1,958
2-5 professionals:						
1 partner	16	3	1,451	2,748	4,066	2,483
2 or more partners	18	4	1,782	3,377	4,930	2,887
6-10 professionals	15	8	2,731	4,566	7,478	3,797
11-20 professionals	14	16	2,532	5,251	7,520	5,398
Over 20 professionals	9	35	5,427	9,811	13,837	8,399
Report Reviews	33	2	123	547	1,850	628

Notes:

1. Cost includes reviewers' time charges, AICPA's 10% administrative fee, and reviewers' expenses.
2. The 1989 reviews include all those conducted on site by PCPS committee-appointed review teams for which the costs were fully processed at the time of compilation. Cost information is not available for firm-on-firm reviews and those administered by state societies or associations.
3. Hourly billing rates for firms with less than 20 professionals and no SEC clients were $75 for team captains, $65 for team members who are partners or proprietors, and $55 for other team members. For firms with 20 or more professionals and all firms with SEC clients, the rates were $10 higher in each classification.
4. PCPS member firms normally incur these costs once every three years.
5. Report reviews are off-site reviews available to firms that perform no audits.

Exhibit 11-6 ***Additional Materials to Be Sent to a Reviewer by a Sole Audit Practitioner with No Professional Staff If the Review Is Not Located On-Site***

- All documentation related to the resolution on independence questions (a) identified during the year under review with respect to any audit or accounting client or (b) related to any of the audit or accounting clients selected for review, no matter when the question was identified if the matter still exists during the review period.
- The most recent independence confirmations received from other firms of CPAs engaged to perform segments of engagements on which the sole practitioner acted as principal auditor or accountant.
- Documentation, if any, of consultations with outside parties during the year under review in connection with audit or accounting services provided to any client.
- A list of relevant technical publications used as research materials, as referred to in question B.4 of the Questionnaire (QRP section 4200.02.B.4).
- A list of audit and accounting materials, if any, identified in response to the questions in the "Supervision" section of the Questionnaire (QRP section 4200.02.C).
- CPE records sufficient to demonstrate compliance with state and AICPA continuing professional education requirements.
- The relevant working paper files and reports on the engagements selected for review.
- Any other evidential matter requested by the reviewer.

The sole practitioner and the reviewer should mutually agree on the appropriateness of this approach.

COMMON PEER REVIEW COMMENTS

Poor or No Documentation of Important Matters

Many comments in prior peer reviews have related to poor documentation of audit planning and supervision including—

- Analytical procedures in the planning stage of the audit.
- Preliminary judgment about materiality, tolerable misstatement, and audit risk assessment.

- Audit sampling planning and evaluation.
- Review of working papers.

Many comments in prior peer reviews have also concerned poor documentation of compliance with quality control policies and procedures, including—

- Resolution of independence problems.
- Consultation on technical issues.
- Inspection program performance.
- CPE in the accounting and auditing area.

Audit Deficiencies

Common audit deficiencies cited in quality reviews include—

- No written audit programs or inadequate programs.
- No client representation letters.
- No legal representation letters.
- No workpapers on consideration of the reasonableness of significant accounting estimates (for example, percentage of completion for a construction contractor).

IMPLEMENTATION ISSUES

State Society's Positive Enforcement Program

If a CPA with primarily an audit and tax practice has all his or her work subject to review in the state society's positive enforcement program, must the firm enroll in the practice-monitoring program, and must the firm have a quality review?

Participation in the state society's positive enforcement program has no effect on the need to enroll or have a quality review. Because the CPA has an audit practice, the firm will require an on-site review.

Personal Financial Planning Practice

Does the practice-monitoring program apply to a CPA whose practice is personal financial planning? Incidental to the financial planning, the CPA compiles personal financial statements and prepares tax returns.

The practice as described includes accounting services—compilation of financial statements. The CPA should be enrolled in the practice-monitoring program and should have an off-site review.

Tax and Consulting Practice

If a CPA's practice is limited to tax and consulting and the firm does not perform any audits, reviews, or compilations, does the firm need to enroll in the practice-monitoring program? Yes, the firm must enroll, but no review will be performed. If the firm accepts an audit, review, or compilation engagement, a quality review must be done within eighteen months from that date.

Prospective Financial Statement Services

If a CPA performs examinations of prospective financial statements, must the firm have a quality review? Performing examinations of prospective financial statements falls under the umbrella of accounting and auditing services. A firm performing such examinations must have a quality review, even if it provides no audits, reviews, or compilations of historical financial statements.

Part Time Practitioners

If a CPA who works as controller fills out tax returns for a fee during the busy season, must he or she enroll in the practice-monitoring program? The CPA must enroll in the program but does not have to have a review because there is no accounting and auditing practice.

Limited Audit Practice Example

A sole practitioner with one professional staff person has one audit client and several clients for which he or she prepares financial statements. What is the difference in the quality review requirements the CPA must meet now versus those that would apply if he or she did not have the audit client?

Because the CPA has an audit practice, he or she must have an on-site review. If the CPA had exclusively an accounting practice (compilation or review of financial statements), he or she would need only an off-site review, which would be far less costly and time-consuming. (Note that because the CPA has a professional staff person, the review must be performed at his or her office and not at the reviewer's office (see earlier discussion of May 1990 interpretation.) Finally, the date of his or her initial review might be as late as 1993 rather than as early as 1991.

The Firm's Quality Control Document

What is a quality control document? It is a description of a CPA firm's policies and procedures for quality control. The document describes, for each of the following nine elements of quality control, the firm's relevant policies and procedures:

1. Independence
2. Assigning personnel to engagements
3. Consultation
4. Supervision
5. Hiring
6. Professional development
7. Advancement
8. Acceptance and continuance of clients
9. Inspection

The document describes the firm's relevant policies and procedures. The document may cross-reference other documents and forms the firm uses for quality control purposes.

Need for a Quality Control Document

Should a small firm with only a few partners have a quality control document? Is the existence of such a document a requirement for a quality review? How does a firm go about preparing such a document?

A quality control document is not required for a quality review. However, it is necessary to complete a quality control questionnaire. An example of such a questionnaire is shown in Exhibit 11-2 of this chapter. While a comprehensive quality control document is not required, this does not mean that a firm can avoid all documentation related to quality control. For example, it would be necessary to maintain CPE records and course materials to demonstrate compliance with continuing professional education requirements.

TIPS 4, "Implementing Quality Control: Forms and Sample Documents," illustrates quality control tools that can be used by firms when establishing their own quality control policies and procedures. It even includes a sample quality control document for a four-partner local CPA firm.

Failure to Use Written Audit Programs

As indicated earlier, one peer review comment that has been common in prior peer reviews of local CPA firms is failure to use written audit programs. This comment is categorized as a departure from GAAS and not simply a lack of documentation. Why?

GAAS require preparation of written audit programs. The absence of written audit programs on an audit engagement is automatically and by itself a serious departure from generally accepted auditing standards (GAAS). In contrast, for example, the auditor is required to make an assessment of the risk of material misstatement. The auditor may make this assessment but fail to document it adequately. There is not necessarily a departure from GAAS as long as the auditor made an adequate assessment and adequately considered the assessment in planning the audit. Auditing standards do not specify minimum documentation requirements for assessing the risk of material misstatement, but they do specify the need for written audit programs.

What Happens If Substandard Performance Is Noted?

The goal of the program is to reduce or eliminate substandard performance through educational and remedial or corrective actions. Disciplinary actions are taken only if the firm refuses to cooperate or when the deficiencies are so serious (for example, fraudulent) that remedial or corrective actions cannot be considered sufficient.

A small firm may have a very informal quality control system and still conform with professional standards. The quality review will find the firm is doing quality work, although some improvements (for example, in documenting adherence to quality control standards) may be suggested. If the small firm is *not* doing quality work, the firm benefits from finding out before the substandard work results in litigation.

Failure to Enroll in the Quality Review Program

The firm must be enrolled in the program or else the partners (or sole practitioner) and CPA employees licensed to practice public accounting will not be permitted to renew their AICPA memberships.

Confidentiality of Quality Review Reports

Who will have access to the firm's quality review report? The review report will be evaluated by the state CPA society or AICPA committee. The state society and AICPA will not make the report available to the state board or anyone else outside of the reviewed firm. The firm has the option to make the report available to the public, if so desired.

SUMMARY

All AICPA members engaged in the practice of public accounting are required to be practicing in a CPA firm that is enrolled in an approved practice-monitoring program—either the AICPA Division for Firms or the AICPA quality review program.

An enrolled firm that performs accounting or auditing engagements must have a quality review every three years administered by either the AICPA quality review division or a participating state society.

The firm under review may select the source of reviewers—CART, CPA firm, or association of CPA firms team—and must sign an engagement letter for the review with the entity forming the review team.

The firm under review must prepare a letter of response to the report and letter of comments of the review team and submit all three documents to the entity administering the review.

Common peer review comments from prior reviews include failure to document adequately aspects of planning supervision such as consideration of audit risk and materiality.

APPENDIX

On-Site Quality Control Policies and Procedures Questionnaire for Firms with Two or More Professionals

This questionnaire provides the reviewer with basic information. It is not necessarily a checklist of all the policies and procedures that might be applicable to a firm's practice. Firms about to be reviewed should respond directly with "yes," "no," or "N/A" answers and briefly describe, where appropriate, the policies and procedures they have in effect that relate to the questions asked. Where appropriate, firms should make reference to any firm documents that describe those policies and procedures in more detail. Examples of such documents might be personnel manuals, audit and accounting manuals, a quality control document or manual, and firm forms and checklists.

	Response, Including Reference to Firm Documents
A. Independence	
1. Does the firm, including all its professional personnel, adhere to the independence rules, regulations, interpretations, and rulings of the—	
a. AICPA?	
b. State CPA society?	
c. State board of accountancy?	
d. State accountancy laws?	
e. SEC and other regulatory agencies?	
2. Describe how the firm informs its professional personnel of the applicable independence requirements (for example, through its personnel manual, audit and accounting manual, training meetings, memoranda).	

Response, Including Reference to Firm Documents

3. How does the firm inform its professional personnel of the new clients to which independence requirements apply? For example, does the firm—
   a. Circulate new client lists to all personnel?
   b. Post new clients on a staff bulletin board?
   c. Report new clients at staff meetings?
   d. Use other (describe) means?
4. Does the firm obtain at least annually written representations from all professional personnel concerning their compliance with applicable independence requirements? If not, how does the firm monitor compliance with its independence policies?
5. Who is responsible for resolving independence questions:
   a. The engagement partner?
   b. The managing partner?
   c. Someone else (identify individual)?
6. In connection with the resolution of independence questions—
   a. In what circumstances must the question and its resolution be documented?
   b. Where is the documentation maintained (for example, the working paper files or other specific firm or client files)?
   c. What sources are or would be consulted?
   d. Has the firm found it necessary within the last year to consult with individuals outside the firm on independence matters?
7. Does the firm have any engagements where it acts as principal auditor or accountant and another

Response, Including Reference to Firm Documents

firm of CPAs is engaged to perform segments of the engagement?

8. If the answer to (7) above is "yes"—
   a. Does the firm confirm the independence of such other firm(s)?
   b. Does it do so in writing?
   c. Does it do so annually?
9. Does the firm review accounts receivables from clients to ascertain whether any outstanding amounts have taken on some of the characteristics of loans and, therefore, may impair the firm's independence?
   a. Who does this?
   b. How often is it done?
   c. Have there been any such situations during the year under review?

B. Assigning Personnel to Engagements

1. Describe the method the firm uses to assign professional personnel to engagements. In that description, include—
   a. The basis on which assignments are made. For example, some firms make assignments on an engagement by engagement basis, others assign personnel to specific clients and hold them accountable for all services to those clients.
   b. How staff are advised of their assignments. For example, some firms do this orally; others issue memoranda or copies of scheduling forms; others post assignments to a staff bulletin board.
   c. Who is responsible for making staff assignments on a day-to-day basis.

Response, Including Reference to Firm Documents

d. How that person is informed of estimated time requirements and of any special skills or experience that a given assignment might demand.

e. How far in advance assignments are typically made.

C. Consultation

1. During the year under review, has the firm sought advice from outside parties to resolve questions involving professional standards or specialized industry practices?
2. How does the firm determine when to consult with outside parties and with whom to consult?
3. Describe the extent to which the firm expects consultations with outside parties to be documented. Where is such documentation maintained?
4. Does the firm's library include current editions of—

   a. AICPA Professional Standards?

   b. AICPA industry audit guides relevant to the firm's practice?

   c. Financial Accounting Standards Board (FASB) pronouncements?

   d. General Accounting Standards Board (GASB) pronouncements, *Government Auditing Standards* (the Yellow Book) and other government audit guides relevant to the firm's practice?

D. Supervision

1. Does the firm follow documented procedures for planning audit and accounting engagements and, if so, where are those procedures found (e.g., in an audit and accounting manual)?

Response, Including Reference to Firm Documents

2. If the answer to (1) is "no," briefly describe the procedures the firm performs in planning audit and accounting engagements in practice, including the information obtained and considered and the nature, timing, and extent of partner involvement in the planning process. Also describe any variations in those procedures based on factors such as the nature and size of the engagement and prior experience on the engagement.
3. Is a written audit program used on all audit engagements?
4. Indicate whether the firm has written guidance materials regarding the following matters. If so, indicate where the material is found and whether it was developed internally or was obtained from an outside source, and name the source.
    a. Evaluation and documentation of internal controls, including computer controls?
    b. Consideration of internal controls in planning the audit?
    c. Audit risk and materiality considerations?
    d. Audit sampling techniques?
    e. Using analytical procedures instead of, or in combination with, tests of details?
    f. Form and content of working papers?
    g. Other audit and accounting matters, in the form of an audit and accounting manual?
5. Does the firm use any standardized forms, checklists, or questionnaires? If so, attach a list and indicate whether the use of each is required or discretionary. (Note that the reviewer will want to inspect these forms during the review.)
6. Has the firm established procedures to be fol-

Response, Including Reference to Firm Documents

lowed when differences of opinion exist among firm personnel on an audit (see AICPA Professional Standards, AU311.14)?

a. Are those procedures documented? Where?

b. Do those procedures allow an assisstant to document his or her disagreement with the conclusion reached?

7. Does the firm use other offices or correspondents for audit or accounting engagements? If "yes," describe the form in which instructions are given to other offices or correspondents and the extent to which their work is reviewed, or indicate where the firm's procedures for the supervision and control of that work is found.

8. Does the firm have documented procedures for review by supervisors and partners of the reports, financial statements, and working papers for—

   a. Audits?

   b. Reviews?

   c. Compilations?

9. If the answer to (8) is "yes," indicate where those procedures are found. If the answer is "no," briefly describe the procedures that are followed, including how the review process is documented.

10. Does the firm require that an individual having no other significant responsibility for the engagement perform a preissuance review of some or all engagements? If "yes," indicate who performs such preissuance reviews and briefly describe the extent of the review and how the review is documented, indicating the types of engagements to which the procedures are applicable. Alternatively, indicate where these procedures are found.

Response, Including Reference to Firm Documents

11. Has the firm merged with any other firm since the date of its last quality review or in the last three years? If "yes"—
    a. Did the firm acquire any professional personnel in such a merger?
    b. Did the firm acquire and retain any new office or offices in such a merger (indicate the locations of any such offices)?
    c. Have the personnel of the merged firm adopted the firm's quality control policies and procedures?

E. Hiring

1. Briefly describe how the firm identifies its professional personnel needs, how it goes about recruiting such personnel, and who makes the decision to hire an applicant.

2. Briefly describe the personal, educational, and experience attributes sought in entry-level personnel and in experienced personnel and indicate whether they are objectives or requirements.

3. Identify the types of background information the firm requires for new hires, such as resumes, transcripts, and personal or employment references.

4. Briefly describe how new professional personnel are informed about the policies and procedures that are applicable to them. Also, attach a list of the manuals, professional publications, and other documents relevant to their professional assignments that are provided to them individually.

Response, Including Reference to Firm Documents

F. Professional Development

1. Are all professional personnel in compliance with state and AICPA Continuing Professional Education requirements (CPE)? If not, attach a list of those personnel who are not in compliance and indicate the firm's plan for correcting the situation.
2. Briefly describe how the firm plans the allocation of CPE hours among accounting and auditing, tax, and other topics and indicate when that is done.
3. Provide an approximation of the nature of the CPE taken by professional personnel assigned to audit and accounting engagements:
   a. Self-study courses .... ______%
   b. In-house training programs—
      (i) Developed by the firm .... ______%
      (ii) Obtained from outside vendors . ______%
   c. State society or AICPA programs ... ______%
   d. Other programs........................ ______%
4. Who maintains CPE records and course materials?
5. How are professional personnel made aware of changes in accounting and auditing standards and in the firm's technical policies and procedures (for example, by distributing technical pronouncements and holding training courses on recent changes and areas noted by the firm as needing improvement)?

G. Advancement

1. What levels of responsibility exist within the firm (e.g., partner, manager, senior)?

Response, Including Reference to Firm Documents

2. Are personnel at all levels aware of the responsibilities of each of these positions? How is this accomplished? Are those responsibilities documented in, for example, a personnel manual?
3. Does the firm periodically evaluate the performance of professional personnel and advise them of their progress in the firm?
   a. When are these evaluations performed?
   b. Are they documented?
4. Are partners periodically evaluated, and by what means (e.g., peer evaluation, self-appraisal, counseling)?
5. Briefly describe how advancement decisions are made (a) within the professional staff and (b) to the partnership.

H. Acceptance and Continuance of Clients

1. Briefly describe the procedures followed by the firm, including any documents generally obtained and reviewed and any inquiries generally made of third parties, before accepting a client for whom the firm will provide audit or accounting services in order to provide the firm with reasonable assurance that the client has integrity, to identify any unusual risks that might be associated with the client, and to evaluate the firm's ability to serve the client in a competent and independent manner. Also indicate, any variances in those procedures, depending on, for example, the services to be provided.
2. Indicate when or under what circumstances current audit and accounting clients are evaluated to determine whether the relationship should be continued, and briefly describe the procedures that are followed.

	Response, Including Reference to Firm Documents
3. Were any audit or accounting client relationships terminated by the firm during the year under review?	

I. Inspection

1. Does the firm perform an annual inspection? If "yes," briefly describe—
   a. The scope of the program, including who carries it out.
   b. The materials used, such as questionnaires, programs, and checklists.
   c. The documentation of the work performed and conclusions reached and the period of time such documentation and conclusions are retained.
2. Has the firm taken appropriate corrective action in response to the findings on its most recent quality review?

SOURCE: AICPA, *Quality Review Program Manual*, Sec. 4300.02 (New York: American Institute of Certified Public Accountants, Inc., 1989).

CHAPTER 12
New Developments in Services for Prospective Financial Statements

CHAPTER 12

New Developments in Services for Prospective Financial Statements

This chapter covers a new Statement of Position (SOP) and a proposed SOP (currently an exposure draft) that modify the AICPA's *Guide for Prospective Financial Statements* issued in 1986. The guide contains the presentation guidelines for prospective financial statements and provides guidance on the accountant's procedures and reports. The prospective financial statements include *forecasts*, which are presentations of management's expectations, and *projections*, which are presentations of a what-if scenario that management does not necessarily believe will happen.

The SOP and the proposed SOP provide additional guidance on prospective financial statements, including partial presentations and internal-use-only information. This chapter explains when prospective financial information is considered to be a *partial presentation*, and describes the accountant's procedures related to partial presentations and required elements of a standard report on a partial presentation. The chapter also describes the reporting requirements when the accountant decides to issue a report on prospective financial statements for *internal use* only.

In addition, the chapter discusses several issues regarding the term *reasonably objective basis* and how to evaluate whether one exists, consideration of the length of the forecast period, and disclosure of long-term results.

DEFINING FORECASTS AND PROJECTIONS

A *forecast* is based on assumptions reflecting conditions the responsible party expects to exist and actions it expects to take. A *projection* is based on the responsible party's assumptions reflecting conditions it expects would exist and actions it expects would be taken given one or more hypothetical assumptions. A *hypothetical assumption* is a condition or course of action that is not necessarily expected to occur but is consistent with the purpose of the projection. For example, a hospital may project operating results after construction of a new wing but is unsure whether it will build the new wing. All other assumptions are actually expected to occur if the new wing is built.

SOP 90-1: INTERNAL-USE-ONLY AND PARTIAL PRESENTATIONS

Reason for Change

Sections 900 and 1000 of the Guide provided limited guidance on the topics of partial presentations and internal-use-only prospective financial statements. That guidance was based on Rule 201(e) of the old AICPA Code of Professional Ethics and the related interpretation 201-2. The interpretation applied to both internal-use-only and partial presentations and addressed the disclosure of assumptions, disclosure of the character of the accountant's work, and the degree of responsibility taken by the accountant.

Both Rule 201(e) and its interpretation were made obsolete in January 1988 when the new Code of Professional Conduct was adopted. SOP 90-1 replaces that old literature and provides additional guidance in the area of services for partial presentations.

Topics Covered

SOP 90-1, *Accountant's Services on Prospective Financial Statements for Internal-Use-Only and Partial Presentations*, applies to both forecasts and projections. Due to the similarities between forecasts and projections, separate guidance for projections is provided only to the extent that it differs from that for forecasts. SOP 90-1 is effective for engagements to provide services on for prospective statements beginning on or after July 1, 1990.

SOP 90-1 and the current exposure draft are not the only amendments to the AICPA *Guide for Prospective Financial Statements* since its issuance. SOP 89-3 concerning accountants' services on prospective financial statements on a variety of specific issues was covered in last year's update and is not repeated here. Topics covered in SOP 89-3 include issues involving projected sale of an entity's real estate investment, reporting on information accompanying a financial forecast in an accountant-submitted document, financial projections included in general-use documents, support for tax assumptions, and periods covered by an accountant's report on prospective financial information.

PARTIAL PRESENTATIONS OF PROSPECTIVE FINANCIAL INFORMATION

One section of SOP 90-1 replaces Section 1000 of the Guide. It provides guidance on—

- The definition of partial presentations and the applicability of the SOP.
- Preparation and presentation of the partial presentation.
- Accountants' procedures related to partial presentations.
- Reports on partial presentations.

Applicability

SOP 90-1 is applicable to an accountant who is engaged to issue or who issues a written communication that expresses a conclusion about the reliability of a written partial presentation that is the responsibility of another party. Thus, applicability is defined in the same manner as other attestation engagements. The SOP also provides guidance to an accountant who is engaged to compile a partial presentation.

Defining *Partial Presentation*

A *partial presentation* is "a presentation of prospective financial information that excludes one or more of the items required for prospective financial statements as described in section 400.06 of the Guide." Section 400.06 specifies the following minimum items required for presentation:

- Sales or gross revenues
- Gross profit or cost of sales
- Unusual or infrequently occurring items
- Provision for income taxes
- Discontinued or extraordinary items

- Income from continuing operations
- Net income
- Primary and fully diluted earnings per share
- Significant changes in financial position

Also, if the omitted information is derivable from the information presented, it would not be a partial presentation.

A partial presentation may be of either forecasted or projected information, and may be either an extract of a full presentation or be specially prepared to meet a specific need. However, estimates in historical financial statements and similar information in note disclosures required by generally accepted accounting principles (GAAP) are not considered partial presentations. Partial presentations are not ordinarily appropriate for general use unless the partial presentation is used to supplement a financial forecast for a period covered by the forecast. *General use* means use by persons who are not negotiating directly with the responsible party. For example, presentation in an offering document for an entity's debt or equity interests would be general use. The phrase *negotiating directly* means that the third-party user can ask questions and negotiate the terms or structure of the transaction directly. The *responsible party* is the person or persons responsible for the assumptions underlying the prospective financial statements. Usually management is the responsible party, but the responsible party could be someone outside.

For limited use circumstances, the presentation must be either complete for what it purports to present considering its intended use, or be the subject of an agreement between the responsible party presenting the forecast or projection and the potential users. The agreement specifies the content of the presentation. For example, a limited use partial presentation may be appropriate in analyzing whether to lease or buy a piece of equipment or in evaluating the income tax implications of a given election. Limited use partial presentations are sometimes used in negotiating the terms of a royalty agreement based on sales (a presentation of prospective sales). However, a partial presentation would generally not be appropriate if it were a statement of forecasted receipts and disbursements that does not include certain existing commitments of the entity, or were a forecast of net income that does not include disclosure of changes in financial position, when such disclosures would indicate the need for additional capital to sustain operations.

When an accountant is engaged to obtain the information and prepare a financial analysis of a potential project, the accountant is the asserter and the analysis is not a partial presentation. For example, if the accountant prepares a lease-or-buy analysis for the client, the engagement is not an attestation engagement.

Preparation and Presentation of Partial Presentations

SOP 90-1 explains the applicability of many requirements in the Guide to partial presentations. Some partial presentations are prepared specially without preparation of full prospective financial statements. If so, the responsible party should consider *key factors* affecting elements, accounts, or items that are interrelated with those presented. An example of a key factor in a sales forecast is whether productive capacity is sufficient to support the forecasted sales. When partial presentations are extracted from prospective financial statements, the effects of such interrelationships among elements should have been already determined.

The title of the partial presentation should be descriptive and indicate its limited nature. The title should *not* state that it is a financial forecast or a financial projection. Examples of appropriate titles include, "Forecast of Production Capacity" and "Projected Operating Income Assuming a New Plant Facility."

Significant accounting policies should be disclosed. When the basis of accounting used is not the same as that used for the historical financial statements, the differences that result must be described but do not have to be quantified.

The measure of materiality should be in relation to the partial presentation taken as a whole.

Significant assumptions should be disclosed. In determining what is significant to the partial presentation, one should consider (1) those assumptions directly related to the presentation (for example, selling price in a sales forecast) and (2) indirectly related assumptions (for example, productive capacity in a sales forecast). In some situations, such as forecasted operating results, the assumptions that need to be disclosed for a partial presentation may include all the assumptions needed for a full presentation.

The introduction preceding the summary of assumptions for a partial presentation should describe the purpose of the presentation and any limitations on its usefulness. SOP 90-1 provides example language for such introductions.

An Accountant's Involvement with Partial Presentations

An accountant may compile, examine, or perform agreed-upon procedures related to the partial presentation. The SOP explicitly states that it does not address partial presentations used solely in connection with litigation support services. The procedures described in the AICPA's *Guide for Prospective Financial Statements* for compilation and examination of prospective financial statements are generally applicable to partial presentations.

When reporting on a partial presentation, the accountant should also consider, among other things, three elements. The first is completeness—whether the partial presentation follows the format requirements specified in the agreement between the responsible party and the potential users. If there is no agreement, the accountant considers whether the presentation is complete for its intended use. The second element relates to key factors and interrelationships, as discussed earlier. The third element is disclosure of assumptions, including consideration of both directly related and indirectly related assumptions that have a reasonable possibility that a variation may significantly affect the prospective information. An accountant should not report on a partial presentation that excludes disclosure of the summary of significant assumptions or, for a projection, that excludes identification of the hypothetical assumptions.

When the accountant is engaged to apply agreed-upon procedures to a partial presentation, the specified users, such as a specific bank or other named creditor, should participate in establishing the nature and scope of the engagement and accept responsibility for those matters. Report distribution should be limited to the specified users. The partial presentation should include a summary of significant assumptions. Section 800 of the Guide provides additional guidance for such engagements.

Reporting on Partial Presentations

Exhibits 12-1 and 12-2 illustrate standard reports on partial presentations. Such a report should include, among other things—

- Identification of the partial presentation.
- A caveat that the forecasted or projected results may not be achieved.

- A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.
- A description of any limitations on the usefulness of the presentation.

Exhibit 12-1 ***Examination Report on a Partial Presentation of Projected Information***

We have examined the accompanying sales projection of XYZ Company for each of the years in the three-year period ending December 31, 19X1. Our examination was made in accordance with standards established by the AICPA and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the sales projection.

The accompanying sales projection presents, to the best of management's knowledge and belief, the Company's expected sales during the projection period that would result if the Company achieved a 15 percent market share of the electric toaster market, as disclosed in items b and c of the summary of significant assumptions. The sales projection and this report were prepared for presentation to the Board of Directors of XYZ Company for its consideration of a new marketing program and should not be used for any other purpose.

In our opinion, the aforementioned sales projection is presented in conformity with the guidelines for a presentation of projected information established by the AICPA, and the underlying assumptions provide a reasonable basis for management's projection of expected sales during the period assuming the Company were to achieve a 15 percent market share of the electric toaster market. However, even if the Company achieves a 15 percent market share, there will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Exhibit 12-2 ***Compilation Report on a Partial Presentation of Forecasted Information***

We have compiled the accompanying forecasted statement of net operating income before debt service, depreciation, and income taxes of AAA Hotel for the year ending December 31, 19X1 (the forecasted statement) in accordance with guidelines established by the AICPA.

Exhibit 12-2 *(cont.)*

The accompanying forecasted statement presents, to the best of management's knowledge and belief, the net operating income before debt service, depreciation, and income taxes of AAA Hotel for the forecast period. It is not intended to be a forecast of financial positions, results of operations, or cash flows. The accompanying forecasted statement and this report were prepared for the ABC Bank for the purpose of negotiating a proposed construction loan to be used to finance expansion of the hotel and should not be used for any other purpose.

A compilation is limited to presenting forecasted information that is the representation of management and does not include evaluation of the support for the assumptions underlying such information. We have not examined the forecasted statement and, accordingly, do not express an opinion or any other form of assurance on the accompanying statement or assumptions. Furthermore, there will usually be differences between forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

There are additional requirements for each type of service the accountant has performed with regard to the prospective information.

Compilation

A report on a compilation of a partial presentation has two additional requirements. It should include a statement that the accountant has compiled the partial presentation in accordance with standards established by the AICPA. It should further state that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the partial presentation or the assumptions.

Examination

A report on an examination of a partial presentation should include a statement that the examination of the partial presentation was made in accordance with AICPA standards and give a brief description of the nature of such an examination. For a forecast, the report should state the accountant's opinion that the partial presentation is presented in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the forecast. For a projection, the report should state the accountant's opinion that the partial presentation is presented in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the projection given the hypothetical assumptions.

Agreed-Upon Procedures

When the accountant has been engaged to perform agreed-upon procedures related to prospective financial information, the report should state that it is intended solely for the specified users and should not be used by others. The report should enumerate the procedures performed and refer to conformity with the arrangements made with the specified users.

If the agreed-upon procedures are less than those performed in an examination, the report should state that the work performed was less in scope than an examination of a partial presentation in accordance with AICPA standards. For a forecast, the accountant should disclaim an opinion on whether the presentation is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the forecast. For a projection, the accountant should disclaim an opinion on whether the presentation is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the projection given the hypothetical assumptions.

The report should also present the accountant's findings based on the agreed-upon procedures, and may include negative insurance.

PROSPECTIVE FINANCIAL STATEMENTS FOR INTERNAL USE ONLY

This section of SOP 90-1 replaces Section 900 of the Guide. It provides accountants with guidance on procedures to be performed in providing services on financial forecasts and projections for internal use only. It reflects the changes in guidance due to deletion of Rule 201(e) and the related interpretation, and expands on the guidance in Section 900 when an accountant decides to issue a report.

Procedures Related to Internal Use Only Prospective Financial Statements

An accountant may compile, examine, or perform agreed-upon procedures on a forecast or projection that is restricted to internal use only. The Guide provides guidance on the types of procedures an accountant performs for these services. In addition, when the forecast or projection is restricted to internal use only, the accountant may provide "any of a spectrum of 'other services' on it." In this case, the accountant should establish an understanding, preferably in writing, with the client regarding the services to be performed. The understanding should also include restriction of the distribution of the prospective information and report to outsiders.

In such an engagement, the accountant should be satisfied that the prospective financial statements are restricted to internal use only. The accountant may rely on the oral or written representation of the responsible party unless contradictory information comes to his or her attention. Also, the accountant should consider the degree of consistency of interest between the responsible party and the user regarding the prospective information. If their interests are the same (for example, both are employees of the entity), the use would be considered internal use. If, on the other hand, the responsible party is a nonowner manager and the user is an absentee owner, the use would not be considered internal use.

Reporting on Prospective Financial Statements for Internal Use Only

The accountant is not required to report on prospective financial statements for internal use only. For example, an accountant can submit a computer-generated financial forecast to a client without reporting on it when the forecast is for internal use only. However, when it is included with a written communication, such as a transmittal letter, the communication should include a caveat that the prospective results may not be achieved and state that the forecast or projection is for internal use only. Note that any type of transmittal letter creates the need for the caveat to be written. An alternative to including the required statements in the letter would be to have the caveat and statement appear in the prospective financial statements themselves.

If the accountant decides to issue a report, there is flexibility in the report form and content. However, the accountant should not issue a report if the prospective financial statements do not include a summary of significant assumptions. Exhibit 12-3 is an example report on a financial forecast limited to internal use only. The SOP states that any such report preferably would—

- Be addressed to the responsible party.
- Identify the statements being reported on.
- Describe the character of the work performed and the degree of responsibility taken with respect to the financial forecast or projection. (*Assembly* is a term used in the professional pronouncements to describe the mathematical and clerical functions related to the presentation of prospective financial statements.)
- Include a caveat that the prospective results may not be achieved.
- Indicate the restrictions as to the distribution of the prospective financial statements and report.
- Be dated as of the date of the completion of his or her procedures.

Exhibit 12-3 ***Report on Forecasted Financial Statements—Internal Use Only***

To: Mr. John Doe, President
XYZ Company

We have assembled, from information provided by management, the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending. (This financial forecast omits the summary of significant accounting policies.) We have not compiled or examined the financial forecast and express no assurance of any kind on it. Further, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. In accordance with the terms of our engagement, this report and the accompanying forecast are restricted to internal use and may not be shown to any third party for any purpose.

(signature)

February 14, 19XX

If the prospective information is a financial projection, the report should describe the limitations on the usefulness of the presentation. If the accountant is not independent with respect to the entity, the accountant should not provide any assurance with respect to the prospective information.

Any omitted disclosures that came to the accountant's attention should be described in the report, or the report should simply state that there are omissions of disclosures required under the guidelines. For example, if forecasted financial statements are included in a personal financial plan, the description may be worded as follows:

> The financial forecast was prepared solely to help you develop your personal financial plan. Accordingly, it does not include all disclosures required by the guidelines established by the American Institute of Certified Public Accountants for the presentation of a financial forecast.

RESPONSIBLE PARTY'S REASONABLY OBJECTIVE BASIS

The AICPA *Guide for Prospective Financial Statements* requires a responsible party (preparer) to have a *reasonably objective basis* for a financial forecast.

Purpose for the Term *Reasonably Objective Basis*

The term *reasonably objective basis* was included in the Guide to communicate to responsible parties a requirement for the level of quality of information necessary to permit presenting a forecast. Situations exist for which no one can reasonably estimate the future outcome because the assumptions are too subjective. For example, forecasting revenues from a newborn thoroughbred racehorse would be very subjective. In this case, it would be inappropriate to present a forecast.

The Guide requires the preparer to have a reasonably objective basis, and the exposure draft of the proposed SOP provides examples and discussion to help the forecast preparer and the accountant in evaluating when such a basis exists.

Evaluation of Whether the Reasonably Objective Basis Exists

The evaluation of whether a reasonably objective basis exists is a matter of judgment. It requires knowledge of the entity's business and industry. A *reasonably objective basis* exists when sufficiently objective assumptions can be developed for each key factor. To determine this, the accountant should consider several questions:

- Can facts be obtained and informed judgments made about past and future events or circumstances in support of the underlying assumptions?
- Are any of the significant assumptions so subjective that no reasonably objective basis could exist to present a financial forecast?
- Would people knowledgeable in the responsible party's business and industry select materially similar assumptions?
- Is the length of the forecast period appropriate?

Exhibit 12-4 is a chart from the draft SOP illustrating other matters to consider.

Which factors are *key factors*? A *key factor* is defined in the Guide as "the significant matters on which the entity's future results depend." What is the significance of the factor to the entity's plans and the dollar magnitude and pervasiveness of the related assumption's effect? Consider the needs of a *reasonable person* who will rely on the financial forecast. If omission or misstatement of the assumption would probably change or influence the judgment of a reasonable person relying on the forecast, then the factor is key.

The accountant also evaluates whether the assumptions are appropriate. Are the assumptions consistent with past or current conditions? Are they consistent with the entity's plans and expectations? Are they consistent with each other? Are the assumptions complete (developed for every key factor)? Note that cost alone is an insufficient reason not to acquire needed information to develop an assumption. However, the cost of incremental information should be commensurate with the anticipated benefit derived.

Were the assumptions developed without undue optimism or pessimism? In the aggregate, do they make sense in the context of the forecast taken as a whole?

Exhibit 12-4 ***Factors to Consider in Determining Reasonably Objective Basis***

Basis	*Less Objective*	*More Objective*
Economy	Subject to uncertainty	Stable
Industry	Emerging or unstable, high rate of business failures	Mature or stable
Entity		
■ Operating history	New or no operating history	Seasoned company or stable operating history
■ Customer base	Diverse, changing customer group	Stable customer group
■ Financial condition	Weak financial position or poor operating results	Strong financial position or good operating results
Management Experience with		
■ Industry	Inexperienced	Experienced
■ The business and its products	Inexperienced or high turnover of key personnel	Experienced
Product or service		
■ Market	New or uncertain market	Existing or stable market
■ Technology	Rapidly changing	Relatively stable
■ Experience	New products or expanding product line	Relatively stable products
Assumptions		
Competing assumptions	Wide range of possible outcomes	Relatively narrow range of possible outcomes
Dependency of assumptions on the outcomes of forecast results*	More dependency	Less dependency

*Assumptions that depend on the achievability of other forecast results.

This guidance applies directly to financial forecasts, but it is also useful in evaluating whether assumptions other than the hypothetical assumptions used in a projection provide a reasonable basis. However, no reasonably objective basis is needed for a projection's hypothetical assumptions.

LENGTH OF FORECAST PERIOD

The responsible party should limit a forecast to periods for which a reasonably objective basis exists. What is the maximum time period to be covered by a forecast?

The Guide does not specify a maximum. Financial forecasts for relatively long periods may sometimes be appropriate. For example, when a long-term contract exists that specifies the timing and amount of revenues, and costs can be controlled within reasonable limits, a relatively long forecast period would normally be acceptable. The exposure draft of the SOP discusses factors to consider in the circumstances to determine whether the time period is appropriate for the particular situation. One factor is the fact that the responsible party should balance the information needs of users with the ability to estimate prospective results (with a reasonably objective basis).

The accountant should also consider that the degree of uncertainty generally increases with the time span of the forecast. The draft SOP states, "It ordinarily would be difficult to establish that a reasonably objective basis exists for a financial forecast extending beyond three to five years and depending on the circumstances, a shorter period may be appropriate..."

If a financial forecast cannot practically be presented for enough future periods to demonstrate the long-term results of an investment or other decision, the presentation should include a description of the potential effects of such results. In other words, there should be narrative disclosure of the potential effects of long-term results in the notes to the forecast presentation for a shorter period.

DISCLOSURE OF LONG-TERM RESULTS

In some circumstances, inclusion of certain disclosures of anticipated events and circumstances beyond the forecast period is necessary to enable users to evaluate the long-term consequences of their investment decisions. What are the relevant disclosure requirements?

Nature of Disclosures

The exposure draft of the SOP indicates that the disclosures should be based on the responsible party's plans and knowledge of specific events or circumstances that are expected to have a material effect on results beyond the forecast period. It lists examples of specific plans, events, or circumstances that might be disclosed, including, for example, (a) expiration of a significant patent or contract, (b) calculation of debt service coverage ratios required to make a balloon payment in a year not covered by the forecast, and (c) returns to investors if a proposed refinancing takes place.

Additional examples of specific plans, events, or circumstances that might be disclosed include (a) a planned refinancing, (b) existing plans for future expansion of production or operating facilities or for the introduction of new products, (c) the expected sale of a major portion of an entity's assets, (d) scheduled/anticipated adverse tax consequences to investors, and (e) estimated costs of and increases in operating capacity resulting from a new facility.

Form of Disclosures

The disclosures may be limited to a narrative discussion of the responsible party's plans or may include estimates of expected effects of future transactions or events. In all cases, the disclosure should include—

- A title that indicates that it presents information about periods beyond the financial forecast period.
- An introduction that indicates that the information presented is not a financial forecast and indicates its purpose.
- Disclosure of significant assumptions made and the specific plans, events, or circumstances that are expected to have a material effect.
- A statement that the information is presented for analysis pur-

poses only and that there is no assurance that the events and circumstances described will occur.

The disclosures should not be presented on the face of the financial forecast, in related summaries of results, or as a financial projection because such presentations could be misleading. The SOP provides illustrations of appropriate disclosures.

The Accountant's Responsibility for the Disclosures

What is the accountant's responsibility for such disclosures when providing compilation or examination services? Because the responsible party does not have a reasonably objective basis to prepare forecasts for those periods, the accountant should not express an opinion or any other form of assurance on the disclosures.

The accountant should perform the following procedures to consider whether the disclosures are obviously inappropriate given their purpose:

- Make inquiries of the responsible party about whether the disclosures are consistent with management's existing plans and knowledge of future events or circumstances.
- Test the mathematical accuracy of any quantified information presented.
- Read the disclosures and consider whether they are presented in accordance with the guidelines (in the draft SOP) and do not appear to be obviously inappropriate in relation to the accountant's knowledge of the entity, its industry, and the compiled or examined financial forecast.
- Confirm his or her understanding of the information presented by obtaining written representations from the responsible party.

For an examination engagement, the disclosures should be marked "Not Covered by the Accountant's Report."

If the accountant concludes that the disclosures are obviously inappropriate given their purpose, the accountant should discuss the matter with the responsible party and propose revision of the disclosures. If the responsible party does not agree, the accountant should either modify the report on the forecast or withdraw from the engagement.

IMPLEMENTATION ISSUES

Determining Prospective Information Is for Internal Use

If an accountant assembles internal-use prospective financial information but decides not to issue a report, he or she must be concerned about ensuring that the presentation cannot reasonably be expected to be used by third parties. The accountant could orally make clear that the presentation should not be used by anyone except the client. The accountant could obtain a written representation to that effect from the client. Alternatively, the accountant might include a standard legend in the printout that the presentation is intended only for client use. If a legend is used, the accountant's name should not appear. The choice among these alternatives is a matter of business judgment.

Computer-Generated Internal Use Only Forecasts—Case Study

Carl Patches, a CPA, acquired a microcomputer several years ago and has been very successful in using it to expand his practice. Patches has constructed a template using an electronic spread sheet that produces complete forecasted financial statements on the tax basis for real estate clients. Patches only has to enter the client's historical financial statements and certain key assumptions. Patches sits down with the client and discusses assumptions and often changes them during the discussion. When both Patches and the client are satisfied that the assumptions are realistic and the statements make sense, Patches prints out only the forecasted statements and gives them to the client. The printout contains no disclosures of any kind and is on the standard continuous paper. Patches' name does not appear anywhere, and Patches issues no report.

Facts

- Patches' clients are very impressed with this service, and Patches does not want to make any changes to his current practice. Does SOP 90-1 require Patches to make any changes? Would you advise Patches to do anything differently in the future?

- Bubba Dog Supplies Mfg., Inc., is considering the sale of a warehouse. Patches is their auditor, and they have sent him the most recent quarterly results and the updated yearly budget. They have asked him what the tax effect of the sale will be. He runs some numbers through his personal computer, and sends two forecasted statements to them—one keeping the warehouse and one selling it at their anticipated terms. His cover letter, addressed to the CFO, states—

  Dear George:

  Enclosed are two scenarios for the warehouse plans. Call me when you get a chance.

  (signature)

  What are Patches' reporting responsibilities in this situation?

Discussion

- Since Patches is not associated with the presentation, omission of significant assumptions is permissible. However, Patches should consider the advisability of continuing this practice. The final presentation is a result of several iterations, and it would be easy to forget what assumptions are embodied in the final version. Adding a printout of the final significant assumptions would be advisable.
- The prospective statements are projections for internal use only, and any written communication, even a transmittal letter, triggers certain requirements. The cover letter should state that the statements are for internal use only. It should further state that the prospective results may not be achieved, whether or not the warehouse is sold, and the differences may be material.

Disclosure of Assumptions Example

The nature and extent of disclosure assumptions for partial presentations varies depending on the nature of the partial presentation. For example, consider the assumptions that would be required to be disclosed for—

- Forecasted sales.
- Forecasted operating results.

For forecasted sales it would be necessary to disclose those assumptions relating directly to the sales forecast, such as future demand and pricing. It might also be necessary to disclose certain other assumptions—such as marketing and advertising programs, productive capacity and production costs, financial stability, or working capital sufficiency. Those assumptions would have to be disclosed when they have a reasonable possibility of a variation significant enough to have a material impact on the sales forecast.

For the forecasted operating results, it is likely that most assumptions that would be significant to a full presentation would be needed.

Length of Forecast Period Case Study

Facts

Two years ago, Carversville Aviation Parts, Inc. obtained a ten-year government contract to supply a wide variety of helicopter maintenance parts. Eight years remain, with the delivery and payment schedules clearly designated in the contract. Carversville has done business with the Army for twelve years. Based on their experience, they expect that the government contract will account for 60 percent of their gross revenue for the next eight years. The remaining 40 percent is expected to come from orders from six current customers regional airline companies, four of whom have been long time customers.

Gerald Carversville, the owner, has asked B. Bass, CPA, to examine a financial forecast prepared to obtain financing to (1) upgrade some of their older equipment to increase efficiency and increase production capacity, and (2) redesign the loading dock area, which has become awkward as business has grown steadily over the years. The lender has requested and Carversville has prepared a forecast for an eight-year period.

Mr. Bass is concerned about the length of the forecast period, but Carversville does not want to fail to meet the lender's request. What would you advise Mr. Bass to do? What are the considerations?

Discussion

The exposure draft indicates that ordinarily it would be difficult to establish that a reasonably objective basis exists for a financial forecast extending beyond three to five years; and depending on the circumstances, a shorter period may be appropriate.

Carversville Aviation is a long-established company with a stable operating history and experienced management. Their customer group has been relatively stable. Bass would have to consider the possibility of obsolescence and changes in helicopter technology. The current customer group is small, so Bass should consider the financial stability of the regional airlines, as well as the effects of losing one or two customers to competition. Bass should also evaluate whether a reasonably objective basis can be developed for the cost assumptions. Can costs be controlled within reasonable limits?

If Bass is satisfied that a reasonably objective basis exists for the assumptions for all key factors, the length of the forecast would be appropriate.

It may be easier to support the conclusion that a reasonably objective basis exists if the forecast were presented as a range.

SUMMARY

Partial Presentations

SOP 90-1 indicates that a partial presentation is a presentation of prospective financial information that omits one or more of the minimum items required by the Guide. A partial presentation ordinarily should not be distributed to third parties who will not be negotiating directly with the responsible party unless the partial presentation is used to supplement a financial forecast for a period covered by the forecast.

For limited use circumstances, the partial presentation must be either complete for what it purports to present considering its intended use, or be the subject of an agreement between the responsible party presenting the forecast or projection and the potential users.

An accountant may compile, examine, or perform agreed-upon procedures related to the partial presentation. The procedures for compilation and examination of prospective financial statements are generally applicable to partial presentations. When reporting on a partial presentation, the accountant should also consider completeness, key factors and interrelationships, and disclosure of assumptions.

Internal Use Only

An accountant may compile, examine, or perform agreed-upon procedures on a forecast or projection that is restricted to internal use only. Also, when the forecast or projection is restricted to internal use only, the accountant may provide any of a spectrum of services on it, based on an understanding with the client regarding the services to be performed. The understanding should include restriction on distribution to outsiders of the prospective information and report.

The accountant is not required to report on prospective financial statements for internal use only. However, when the prospective information is included with a written communication, such as a transmittal letter, the communication should include specified caveats.

Exposure Draft

A *reasonably objective basis* exists when sufficiently objective assumptions can be developed for each key factor.

The length of the forecast period must not exceed the period for which a reasonably objective basis exists. The degree of uncertainty generally increases with the time span of the forecast. It ordinarily would be difficult to establish that a reasonably objective basis exists for a financial forecast extending beyond three to five years and, depending on the circumstances, a shorter period may be appropriate.

Disclosures of long-term results beyond the forecast period should conform to the requirements specified in the exposure draft, including clear designation that the long-term results are not part of the forecast.

CHAPTER 13
Internal Control Structure

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Internal Control Structure

Auditors should be aware of two significant developments related to internal control:

1. Statement on Auditing Standards (SAS) No. 55 has become effective, and new practice aids have been developed to assist auditors in implementing its requirements.
2. The Securities and Exchange Commission has proposed a requirement for public companies to assess the effectiveness of their internal control structure and report the results publicly.

SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* is the last of the so-called expectation-gap SASs to become effective. It is effective for audits of financial statements for periods beginning on or after January 1, 1990. Thus, it must be applied in the planning of audits of clients with annual financial statements for years ended December 31, 1990, and later.

This chapter does not attempt to provide comprehensive coverage of SAS No. 55. It is designed to help you in applying SAS No. 55. This chapter focuses on practical advice on implementation. It explains the practice aids that are available to implement SAS No. 55 and focuses on the new control risk audit guide. This audit guide is the result of a special project undertaken by the Auditing Standards Board to provide implementation guidance for SAS No. 55 before the SAS became effective. This chapter also explains the basic differences between the new requirements of SAS No. 55 and the prior requirements of Professional Standards AU Section 320 because existing practices will need to be changed to comply with the new standards.

The final section of the chapter explains the SEC's proposed rules requiring reporting on internal control.

SAS NO. 55 VERSUS PROFESSIONAL STANDARDS AU SECTION 320

SAS No. 55 does more than change terminology. It is both a new way of thinking and talking about internal control. SAS No. 55 expands *both*

- Knowledge needed in every audit about the control environment, accounting system, and control procedures.
- Documentation—of elements and risk assessment.

Expanded Knowledge Required About the Internal Control Structure

Professional Standards AU Section 320 required the auditor only to obtain an understanding of the control environment and the flow of transactions through the accounting system. Obtaining an understanding of control procedures was necessary only if the auditor intended to rely on internal accounting control. Documentation of any aspect of the understanding obtained—whether of the environment, accounting system, or control procedures—was not necessary unless the auditor intended to rely on internal accounting control. The literature did not explicitly permit the auditor to rely on the control environment or the accounting system in establishing the scope of substantive tests, and there was disagreement about whether and to what extent such reliance might be appropriate.

SAS No. 55 requires the auditor to obtain an understanding of the control environment, the accounting system, and control procedures sufficient to plan the audit. The auditor is required to document the understanding obtained to plan the audit, but the extent of the documentation will vary with the size and complexity of the client. While the auditor is required to obtain an understanding of all three elements, there does not need to be a comprehensive understanding of each element in each case. In certain circumstances, the auditor may be able to assess control risk below the maximum based on the understanding of the internal control structure obtained to plan the audit—primarily the understanding of the control environment and the accounting system—and restrict the scope of substantive tests.

Control Risk Assessment

SAS No. 55 replaces the notion of reliance on internal control with the concept of control risk assessment. The notion of reliance implied a yes or no decision. In contrast, under SAS No. 55, the auditor assesses control risk along a continuum from a maximum level to a minimum level. Also, the assessment is based on the knowledge of all three elements of the internal control structure and not confined to control procedures. SAS No. 55 requires the auditor to document the basis for an assessment of control risk at less than the maximum level.

PRACTICE AIDS AVAILABLE

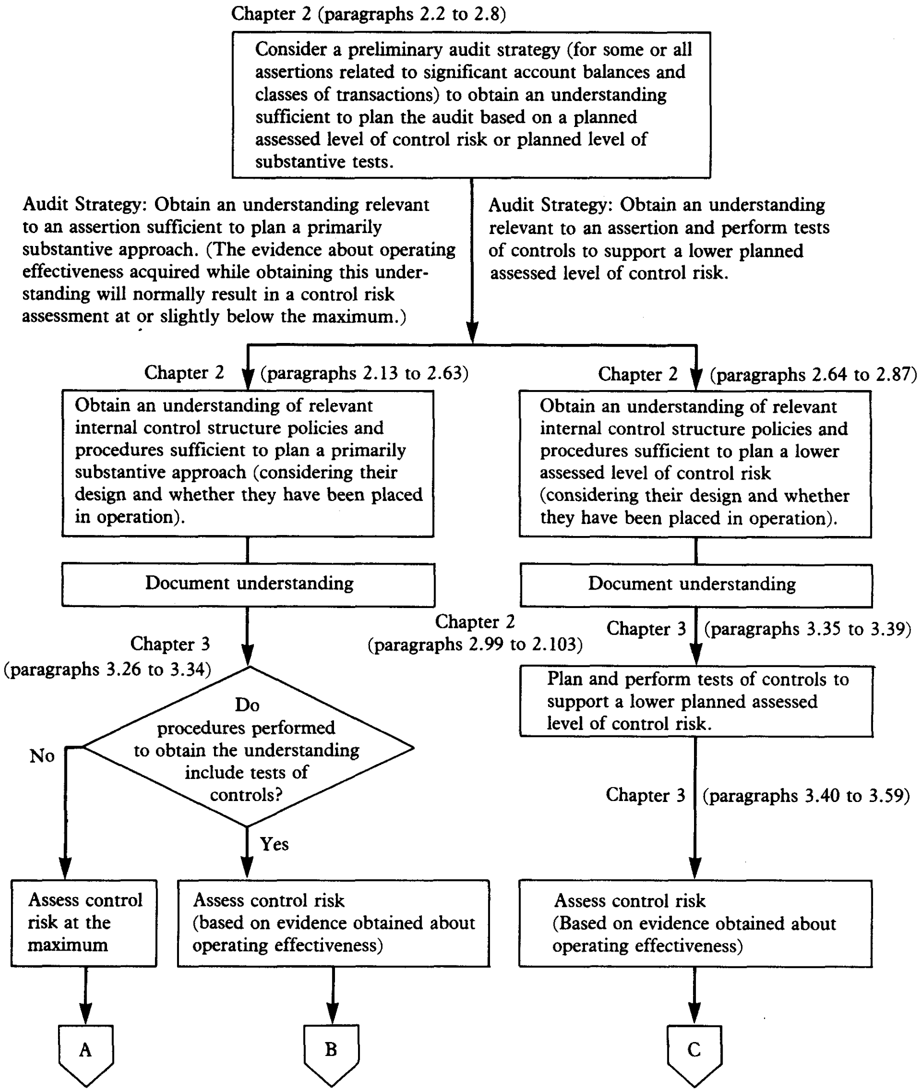
Control Risk Audit Guide

The AICPA audit and accounting guide, *Consideration of the Internal Control Structure in a Financial Statement Audit* is available from the AICPA order department. It explains the implementation of SAS No. 55 and illustrates documentation of the auditor's understanding and control risk assessment for three types of clients, using three example companies:

- Ownco, Inc., a small owner-managed business, with a single bookkeeper and a microcomputer-based accounting system
- Young Fashions, Inc., a nonpublic company with multiple locations and a minicomputer-based accounting system that is not fully meeting the needs of the fast-growing company
- Vinco, Inc., a large public company with multiple locations and accounting systems processed on a mainframe computer

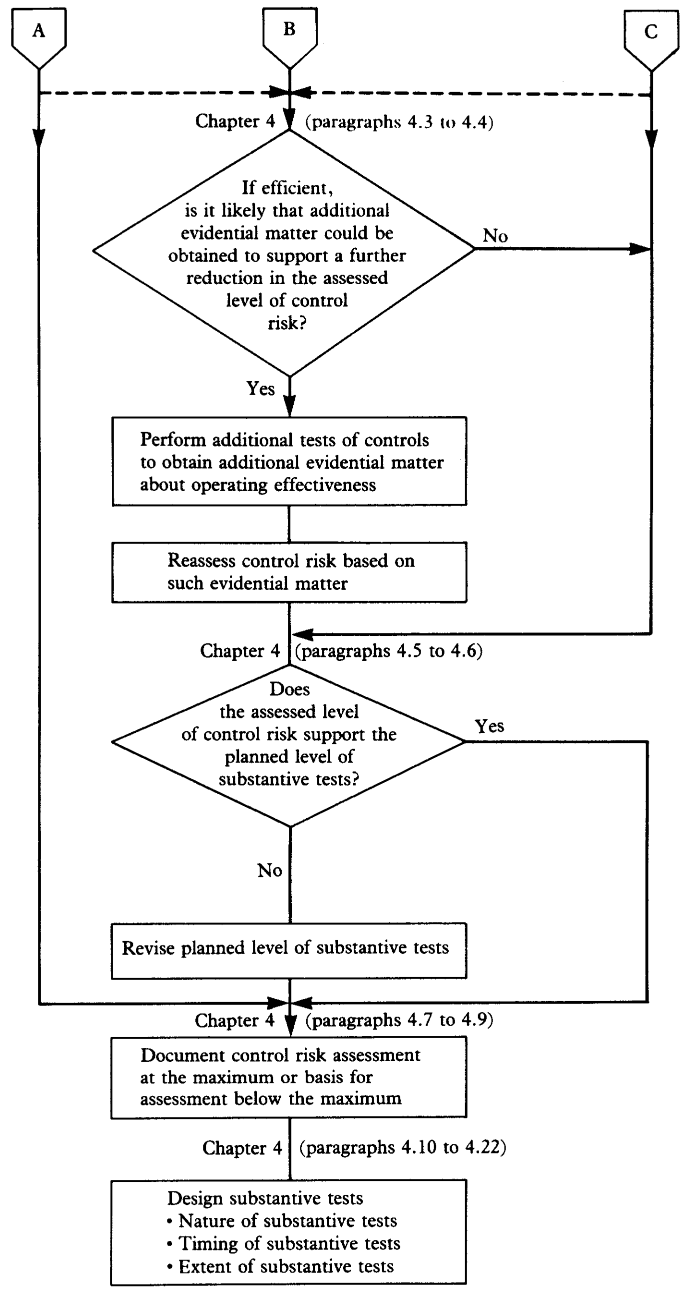
The guide contains a flowchart—reproduced here as Exhibit 13-1—intended to simplify the implementation of SAS No. 55. The auditor who follows the left side of the flowchart is taking a primarily substantive approach to the audit. This approach will often be used for audits of small businesses. (This subject is discussed in more detail later in this chapter.) The right side of the flowchart indicates the steps when a lower assessed level of control risk is planned.

Exhibit 13-1 ***Flowchart of the Auditor's Consideration of the Internal Control Structure and Its Relation to Substantive Tests For Some or All Assertions***



NOTE: This flowchart is intended to present only one conceptual way to view the auditor's consideration of the internal control structure, and it does not imply a specific sequencing of steps in the performance of an audit. In addition, there may be other strategies that the auditor may follow.

Exhibit 13-1 ***(cont.)***



Some auditors have observed that the guide has an "EDP bias." However, the guide is not limited guidance relevant to large mainframe systems. It also addresses the small company's microcomputer system and the effects on the audit.

One of the guide's valuable contributions is its illustrations of documentation of the auditors' understanding of the internal control structure and documentation of tests of controls. Alternative documentation styles are presented, giving the reader an understanding of the options that are available to the auditor.

Examples of how the auditor's control risk assessment affects the nature, timing, and extent of substantive tests are also presented.

Journal of Accountancy Articles

Several articles have been published in the *Journal of Accountancy* that provide implementation advice on SAS No. 55.

Robert H. Tempkin and Alan J. Winters wrote an article entitled, "SAS No. 55: The Auditor's New Responsibility for Internal Control." It appeared in the May 1988 issue of the *Journal of Accountancy* and it explains the essential points of SAS No. 55.

Harold L. Monk, Jr., and Kay W. Tatum wrote "Applying SAS No. 55 in Audits of Small Businesses," published in the November 1988 *Journal of Accountancy*. This article focuses on how to apply SAS No. 55 in the audit of a small business—a business with management control concentrated in one or a few individuals and limited segregation of duties. It illustrates efficient methods of meeting the documentation requirements. Exhibit 13-2 is from this article. It illustrates the relationship between elements of the internal control structure and assertions for accounts receivable. Exhibit 13-3 from this article illustrates documentation of the control risk assessment for accounts receivable.

Exhibit 13-2 ***Considering the Internal Control Structure When Assessing Control Risk for Accounts Receivable****

Information Provided by Required Understanding	*Relationship to Financial Statement Assertions*
Control Environment	
1. Owner-manager doesn't place undue emphasis on favorable financial position and earnings and isn't unduly aggressive in taking risks.	*Existence:* Indicates the owner-manager's attitude toward risk doesn't suggest a disposition to overstate sales revenues or accounts receivable.
2. Owner-manager follows up on customer complaints concerning monthly statements.	*Existence and valuation:* Indicates that erroneous amounts or transactions may be identified by follow-up on complaints regarding monthly customer statements.
3. Owner-manager approves all credit transactions.	*Existence and valuation:* Indicates sales are to valid customers who will pay their bills.
4. Owner-manager approves all noncash credits to customer.	*Existence, completeness and valuation:* Indicates that write-offs of accounts receivable are valid transactions and that consideration is given to the collectibility of accounts receivable.
5. Owner-manager prepares a basic budget and follows up on significant variances.	*Existence and valuation:* Indicates that significant variations from budget (over or under) for accounts receivable are investigated to determine cause.

(continued)

Exhibit 13-2 *(cont.)*

Information Provided by Required Understanding	*Relationship to Financial Statement Assertions*
Accounting System	
6. Prenumbered shipping documents, invoices and credit memos are used.	*Existence and completeness:* Assures that billings are for valid transactions and products shipped are billed.
7. Unused documents are voided, and voided documents are controlled.	*Existence and completeness:* Same as 6 above.
8. Quantities shipped are reconciled to quantities billed.	*Completeness:* Assures that accounts receivable are complete.
9. Approved price lists are used for billing.	*Valuation:* Assures the right price is billed to the customer.
10. Customer trial balance is reconciled to control account.	*Existence and completeness:* Assures that all valid credit transactions are recorded in customer accounts.
11. Monthly statements are mailed to customers.	*Existence and valuation:* Assures that recorded accounts receivable are valid and properly valued.
Control Procedures	
12. Invoices are internally verified for pricing, extension and footing.	*Valuation:* Assures that accounts receivable were properly billed.

Note: For purposes of illustration, the linkage between the control policies and procedures and the financial statement assertions is documented. Such documentation isn't required by SAS No. 55.

SOURCE: Harold L. Monk, Jr., and Kay W. Tatum, "Applying SAS No. 55 in Audits of Small Businesses," *Journal of Accountancy*, November 1988.

Exhibit 13-3

Assessing control risk

We have assessed control risk at the maximum level for all financial statement assertions and have designed our substantive audit procedures accordingly, with the following exceptions. For those significant account balances indicated below, we have assessed control risk at less than the maximum level for assertions related to the tests of controls on policies and procedures described and/or referenced. The effects of such assessment have been reflected in our audit program.

________ Cash   Workpaper reference ________

__X__ Accounts receivable   Workpaper reference ___*___

Our tests of controls for the existence and valuation assertions indicate that effective controls have been in place during the year. Accordingly, positive confirmation procedures will be used for balances over $3,000 and 5% of all other.

________ Inventory   Workpaper reference ________

________ Accounts payable   Workpaper reference ________

________ Revenues and expenses   Workpaper reference ________

* The auditor should refer to (1) relevant documentation of the internal control structure and (2) results of tests of controls on policies and procedures related to assertions for which control risk has been assessed at less than the maximum level. Additionally, the auditor may reference the results of other tests (such as confirmation procedures) that support the position that the assessment was reasonable.

SOURCE: Harold L. Monk, Jr., and Kay W. Tatum, "Applying SAS No. 55 in Audits of Small Businesses," *Journal of Accountancy*, November 1988.

AICPA Audit and Accounting Manual (AAM)

Audit and Accounting Manual (AAM) Section 4000 on Internal Control Structure illustrates approaches to the implementation of SAS No. 55. It includes the following sections:

a. 4100—Introduction
b. 4200—General Approach
c. 4250—Internal Control Structure Considerations in a Minicomputer Environment
d. 4300—Illustrative Internal Control Structure Questions—Small Business
e. 4400—Illustrative Specific Internal Control Structure Objectives and Related Questions—Medium to Large Business
f. 4500—Flowcharts
g. 4600—Illustrative Internal Control Structure Questions—State and Local Governmental Units
h. 4700—The Auditor's Assessment of Control Risk.

Appendixes A and B to this chapter illustrate the approach used in the AAM. Appendix A illustrates the questions on the control environment and the accounting system and control procedures for revenues and accounts receivable. Appendix B illustrates a method of documenting the auditor's control risk assessment. This particular illustration focuses on revenues.

Course

There is a one-day AICPA course prepared by Don Pallais called "Internal Control: The Auditor's New Responsibilities."

A "LEFT-SIDE" STRATEGY

Left-Side Versus Right-Side Strategy

Exhibit 13-1 reproduced from the control risk audit guide, illustrates two categories for a preliminary audit strategy. The strategy shown on the left is the one that is generally considered the normal approach for a small business. The strategy on the right is used when the control environment (for example, good segregation of duties) and other elements of the internal control structure indicate a likelihood that a lower assessed level of control risk would be advantageous to use.

Features of a Left-Side Strategy

The left-side strategy means assessing control risk at or slightly below the maximum level and taking a primarily substantive approach to the audit. Using this approach, the auditor first obtains an understanding of relevant internal control structure policies and procedures sufficient to plan a primarily substantive audit.

The procedures needed to obtain a sufficient understanding are not as extensive as those needed when the auditor is planning a lower assessed level of control risk. Procedures performed to obtain the understanding of the internal control structure relating to certain assertions may also serve as tests of controls if they provide evidence of operating effectiveness. The auditor documents the understanding, and this documentation is also less extensive than that needed for a right-side strategy. An auditor that starts with a left side approach is not precluded from changing to a right-side approach. That is, the auditor may decide that it is efficient to perform tests of controls to reduce the assessed level of control risk if the internal control structure based on his or her understanding merits it.

After obtaining a sufficient understanding of the internal control structure to plan the audit, the auditor then documents the control risk assessment at the maximum—or documents both the assessment and the basis for the control risk assessment below the maximum—and designs the substantive tests.

IMPLEMENTATION ISSUES

Influence of Control Environment on Risk Assessment

Is a strong control environment by itself sufficient to support an assessment of control risk below the maximum level?

An effective control environment affects the auditor's control risk assessment, but the auditor does not assess control risk based solely on understanding and testing the control environment. The auditor assesses control risk after obtaining an understanding of each of the three elements of the internal control structure and performing tests of controls to obtain evidence about the design and operating effectiveness of the related policies and procedures. The auditor does not assess control risk for individual elements of the internal control structure, but considers the combined aspects of the control environment, the accounting system, and control procedures when assessing control risk.

Because an understanding of all control procedures is often not necessary for audit planning, the interaction of the control environment, accounting system, and control procedures may be significantly influenced by the control environment and accounting system. However, to assess control risk below the maximum, the auditor needs to identify specific policies and procedures relevant to specific financial statement assertions and evaluate the effectiveness of their design and operation.

Use of Evidence from Prior Years

Can the results of tests of controls performed in prior years be used in the current audit as a basis for evaluating the effectiveness of the operation of policies and procedures without repeating the tests of controls?

It is always necessary for the auditor to establish whether policies and procedures tested in prior years have changed in the current year before using evidence from prior years. Thus, the susceptibility of policies and procedures to change is the key to answering this question. The more susceptible a policy or procedure is to change, the greater is the need to update the test of controls to conclude whether the policies and procedures continue to operate effectively.

A daily reconciliation procedure is very susceptible to change because of employee turnover and fluctuations in the volume of transactions. On the other hand, a written policy statement may change very little, and any changes are readily observable. Thus, the auditor would be more likely to perform tests of controls related to daily reconciliation procedures, but might confine work on the existence of a written policy statement to inquiry and observation to determine whether the policy changed.

One significant use of evidence from prior years is in documentation. The documentation of the understanding from prior years only needs to be updated for changes.

Maximum Level of Control Risk

What is the maximum level of control risk, and what is the significance of an assessment at the maximum level?

The glossary to SAS No. 55 defines the maximum level of control risk as "the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure."

The appendix to SAS No. 39 (Professional Standards AU Section 350) on audit sampling seems to indicate that an assessment at the maximum would mean 100 percent in quantitative terms. Some accountants have questioned this conclusion, but the authoritative literature is clear that when a quantitative assessment is made, maximum means 100 percent. A distinction should be drawn, however, between the auditor's planned assessment of control risk for purposes of initially planning the extent of substantive tests versus the auditor's best estimate of the actual, but unknown, level of control risk associated with the client's actual internal control structure.

An assessment at the maximum level in audit planning normally means that the auditor, usually for reasons of audit efficiency, has assigned a value of maximum to the control risk. This assigned value of maximum does not necessarily mean that the auditor believes there is a virtual certainty that material misstatement has occurred.

Some auditors may be tempted to assess the level of control risk for many assertions at the maximum level to avoid the uncomfortable new complex requirements for ensuring that a lower assessed level is properly supported by procedures performed and properly documented in the work papers. However, in some cases where a lower assessed level is clearly warranted, the auditor who assesses control risk at the maximum will be required to do a burdensome amount of substantive testing that would not be needed for a lower assessed level of control risk. For example, the procedures needed to audit the completeness assertion related to revenues of a charity that receives significant cash donations would be significantly increased in scope if control risk were assessed at the maximum level.

The Number of Control Risk Assessments Required in One Audit

SAS No. 55 (Professional Standards AU Section 319.29) states: "Control risk should be assessed in terms of financial statement assertions." SAS No. 31 (Professional Standard Section AU 326.03) explains that assertions may be classified according to the following five broad categories:

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Does this mean that in an audit of financial statements only five control risk assessments are necessary—one for each assertion—or does it mean that the number of risk assessments that are necessary is five times the number of account balances in the client's trial balance?

There are certainly more than five assessments to be made. SAS No. 55 and the control risk audit guide use "assessment at the assertion level" as a shorthand phrase. It does not mean, for example, that one assessment is made of the existence assertion for all assets. Controls related to the existence of accounts receivable have little relationship to controls related to the existence of fixed assets. It should be understood that assertions apply to particular account balances. In fact, SAS No. 55 (Professional Standards AU 319.27) states: "In planning and performing an audit, an auditor considers these assertions in the context of their relationship to a specific account balance." The point of SAS No. 55 is that the auditor cannot simply assess control risk for an account balance as a unit (for example, accounts receivable), because the risk of overstatement (existence) has different causes and a different likelihood than the risk of understatement (completeness) for the same account balance. Understatement can arise from goods being shipped, but not billed. Overstatement can arise from billing a customer for goods shipped on consignment. The likelihood of these misstatements occurring in a particular circumstance is only the same by coincidence, and the relevant aspects of the internal control structure that affect control risk are generally different for overstatement versus understatement.

On the other hand, there are probably fewer assessments than five times the number of account balances in the client's trial balance for several reasons. Some account balances will be grouped for financial statement purposes. Further, if the auditor plans to assess the level of control risk for one assertion for an account balance as low, it will often be necessary for practical reasons to have the same assessment for related assertions affecting the same account balance. For example, if the auditor plans to restrict the confirmation of accounts receivable based on a low assessed level of control risk, it will be necessary to have the same level of control risk for all assertions substantiated by the confirmation procedure.

Finally, the assessment of control risk for some assertions may have no influence on the scope of procedures. Existence, completeness, and valuation are significant assertion categories for most account balances. However, rights or obligations and presentation and disclosure are assertions for which an assessment of control risk may have no influence on the scope of substantive tests in many cases.

Use of Evidence from Prior Period Assessment

SAS No. 55 (Professional Standards AU Section 319.53) states: "Evidential matter about the effective design or operation of internal control structure policies and procedures that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit." If an auditor tested the operation of a control procedure in the prior period by selecting a sample of twenty-five transactions, does the quoted passage mean the auditor this year may base the control risk assessment for the same procedure on (a) the results of last year's sample with no transactions selected this year, (b) a sample of ten this year combined with the results of last year, or (c) a new sample of twenty-five?

Several factors would affect the appropriate sample size for a selection of transactions to test controls. First, has the auditor's planned assessed level of control risk changed? For example, is the auditor planning to assess control risk as moderate in both years, or does the auditor hope to lower the assessment this year? Another consideration is whether the auditor expects the same or a different rate of exceptions as a result of making the test of controls. For example, if the auditor expected and found no exceptions last year, has that expectation changed?

Assuming that all other things remain equal, the only issue would be the appropriateness of using evidence from last year's sample results. SAS No. 55 and the audit guide do not address this question explicitly, but lowering the sample size based on prior year's evidence seems clearly inappropriate. The kinds of control procedures that are tested by reperformance are susceptible to change because of employee turnover, changes in the nature and volume of transactions, and the normal problems of human fallibility (stress, fatigue, etc.).

There is normally a serious risk that the effectiveness of control procedures will deteriorate from the prior period. A smaller sample size would be less likely to detect a deterioriation in operation effectiveness. Thus, the auditor should never count items tested in the prior period as part of this year's sample.

The auditor could use prior evidence to determine the appropriate sample size by considering the likely rate of exceptions. Assume the auditor in the prior period expected no exceptions and took a sample of twenty-five, but found two exceptions. The rate of exceptions found last year would indicate a need to increase sample size in the current year assuming the auditor still believes that testing controls and assessing control risk below the maximum is still the most efficient audit approach.

Meaning of *Assessed Level of Control Risk*

Does the phrase *assessed level of control risk* always mean exactly the same thing? It is possible to distinguish four different meanings for the term:

1. The true but unknown level of control risk in the client's circumstances
2. The auditor's best estimate of the true level of risk before tests of controls
3. The auditor's best estimate of the level of risk after tests of controls
4. The auditor's assigned value for control risk as a convenience for planning purposes—maximum level

The context of the phrase is important in determining which of these meanings was intended in the circumstances.

THE SEC'S PROPOSED RULES FOR REPORTING ON INTERNAL CONTROL

The Securities and Exchange Commission (SEC) has issued a rule proposal, *Report of Management's Responsibilities*. If adopted, public companies will be required to assess the effectiveness of their internal control structure and report the results publicly. The assessment would be included in a management report, which would also contain management's response to internal and independent auditors' significant recommendations regarding internal control. A significant recommendation is defined as a "reportable condition" as described in SAS No. 60. The management report would also contain management's acknowledgment of its responsibilities for preparing the financial statements in accordance with generally accepted accounting principles (GAAP) and for establishing and maintaining the internal control structure.

The SEC proposal does not require the management report to be audited. However, some public companies will probably have their auditors examine and report on the internal control structure even without a requirement. The auditing standards board is currently developing a statement on attestation services to address this type of engagement.

Respondents to the proposal strongly opposed the requirement that management respond to significant recommendations of internal and independent auditors. The majority of respondents also opposed the requirement for management to assess the effectiveness of its internal control structure. In spite of the response, it is anticipated that the SEC will issue the rule without significantly changing the requirements as proposed.

One anticipated effect on public companies is that management will probably have to document its internal control structure policies and procedures more extensively.

A key issue still to be resolved is the SEC's definition of what is included in internal control—only accounting controls or inclusion of management and operating controls as well. Another key issue is development of the SEC's criteria to evaluate the effectiveness of the internal control structure. Such criteria have not yet been defined.

SUMMARY

SAS No. 55 requires the auditor to obtain more knowledge about the internal control structure than was required by Professional Standards AU Section 320 and also requires more documentation.

The auditor should obtain an understanding of all three elements of the internal control structure—control environment, accounting system, and control procedures—and document the understanding and the basis for assessment of control risk at less than the maximum.

Several practice aids have been developed by the AICPA to facilitate the implementation of SAS 55, including the control risk audit guide, *Journal of Accountancy* articles, and a section of the AICPA audit and accounting manual.

A left-side strategy refers to the left side of the flowchart in the control risk audit guide and means a strategy of assessing control risk at or slightly below the maximum level and taking a primarily substantive approach to the audit.

An effective control environment affects the auditor's control risk assessment, but the auditor does not assess control risk based solely on understanding and testing the control environment.

In deciding whether evidence from prior years is pertinent to an assessment of control risk in the current year, the auditor needs to consider the susceptibility of the relevant policies and procedures to change.

An assessment of control risk at the maximum level means 100 percent in quantitative terms and is usually an assigned value made for convenience in audit planning rather than a judgment that there is virtual certainty that a material misstatement has occurred.

The SEC has issued a proposed rule requiring public companies to issue a management report containing their assessment of their internal control structure, their responses to significant recommendations by internal and external auditors, and their acknowledgment of responsibility for preparing the financial statements and for establishing and maintaining the internal control structure.

APPENDIX A

AAM Section 4300
Illustrative Internal Control Structure Questions—Small Business

.010 The following is a list of illustrative internal control structure questions an auditor might raise concerning a small manufacturing operation owned by one person who also serves as the general manager and has only a few employees involved in the accounting function. These illustrative questions assume that accounting services will be performed by the CPA in compiling financial statements. These illustrative questions are numbered merely for organization purposes; the numbers are in no way intended to infer completeness or a preferred sequence. This list will require modification for other types of entities. Because this list is merely illustrative, some auditors may find it not extensive enough, while others may find it too detailed. Others may prefer a different organization or sequence for the inquiries. A firm that believes the questionnaire approach is appropriate for its practice should develop its own internal control structure questionnaires based on its own needs and preferences. In any event, users of checklists and questionnaires should recognize that important matters in a particular set of circumstances may not be covered in a standard checklist.

.020

I. Control Environment

1. Does the owner reasonably understand the form and content of the financial statements and such required reports as tax returns?
2. Does the owner use operating budgets and cash projections? If so,
   a. Do the budgets and projections lend themselves to effective comparison with actual results?
   b. Are material variances reviewed and explained?
3. Are monthly comparative financial reports prepared which are sufficiently informative to highlight abnormalities?

4. Is there adequate control including a reporting schedule and assigned responsibility for preparation of required financial statements and government regulatory reports?
5. Are the personal funds of the owner including his or her personal income and expenses completely segregated from the business?
6. Is the bookkeeper required to take annual vacations, and does someone else perform the bookkeeping duties during that time?
7. Are there adequate safekeeping facilities for custody of the accounting records such as fireproof storage areas and restricted access cabinets?
8. Is there adequate fidelity bond coverage of employees who handle cash, securities, other valuable assets and accounting records?
9. Is the adequacy of insurance coverage periodically reviewed?
10. Is there a suitable records retention plan?
11. Is the owner satisfied that all employees are competent and honest?

II. Accounting System and Control Procedures*

.030 A. General

1. Is a complete and current chart of accounts used?
2. Is a double entry bookkeeping system in use which includes a general ledger, source journals, and suitable subsidiary records?
3. Do the records provide for efficient accumulation of entries and avoidance of unnecessary duplicate work?
4. Are standard journal entries used to the extent practicable?
5. Are journal entries understood and authorized by the owner?

*The accounting system and control procedure elements are combined because they are highly interrelated and often inseparable. Generally, the auditor has a greater responsibility to understand the accounting system than to understand specific control procedures.

6. Are the source journals posted promptly and the general ledger and subsidiary ledgers kept current and balanced monthly?

.040 B. Identified Significant Classes of Transactions

1. Revenue cycle (revenue, receivables, and cash receipts)?
2. Expenditures cycle (purchases, payables, payrolls, cash disbursements)?
3. Production or conversion cycle (inventories, cost of sales, property, plant, and equipment)?
4. Financing cycle (notes receivable, investments, notes payable, debt, other long-term obligations, and owner's equity)?

III. Revenue Cycle (Revenue, Receivables, and Cash Receipts)

.050 A. Understanding—Revenues and Accounts Receivable

1. How are sales transactions initiated?
2. What document or record is used to evidence initiation?
3. What are the responsibilities of personnel involved with initiating sales?
4. How are sales transactions recorded?
5. How often are sales journal entries prepared?
6. How are collections received?
7. What document or record is used to evidence collections?
8. What are the responsibilities of personnel involved with collections?
9. How often are bank deposits made?
10. How are credits to customer's accounts initiated?
11. What documents are used to evidence credits?
12. What are the responsibilities of personnel involved with initiating credits?

.060 B. Control Procedures—Revenues and Accounts Receivable

1. Is credit approved by the owner or a designated credit manager?

2. Are credit files maintained on a current basis for significant customers?
3. Are commission rates set or approved by the owner?
4. Are sales orders or work orders approved by the owner or a responsible employee for—
   a. Price?
   b. Terms of sale, including delivery dates?
   c. Credit?
   d. Account balance limits?
5. Are all sales orders (or work orders) recorded on prenumbered forms, and are all numbers accounted for?
6. Are shipping documents—
   a. Prepared for all shipments?
   b. Prenumbered and all numbers accounted for?
   c. Based on approved sales orders and matched with sales invoices?
   d. Processed promptly?
7. Are all sales invoices—
   a. Prenumbered and all numbers accounted for?
   b. Compared to shipping documents?
   c. Checked for price and terms?
   d. Checked for clerical accuracy?
   e. Recorded promptly?
8. Are all credit memos prenumbered and all—
   a. Numbers account for?
   b. Approved?
   c. Recorded promptly?
9. Is there a proper cut-off sales at month end?
10. Are monthly statements of account for all trade receivable balances—
    a. Reviewed by the owner before mailing?
    b. Mailed by the owner or a responsible employee other than the bookkeeper?

11. Is the accounts receivable subsidiary ledger balanced monthly to the general ledger control account?
12. Is an aging schedule or schedule of past-due customers' accounts prepared monthly?
13. Does the owner or credit manager review monthly listings of past-due customer accounts and investigate delinquent accounts and unusual items?
14. Are write-offs and other adjustments to customers' accounts authorized by the owner?

APPENDIX B

Sample Control Risk Assessment Documentation

ABC Company
Assessment of Control Risk—
December 31, 19X5

Transaction Class or Account Balance:	*Financial Statement*			*Assertions*	
Revenues	*Existence Occurrence*	*Completeness*	*Rights/ Obligations*	*Valuation Allocation*	*Presentation/ Disclosure*
Relevant Internal Control *Structure Policies/Procedures:*					
1. Use of prenumbered shipping documents	√	√	N/A	N/A	N/A
2. Shipping documents matched with prenumbered invoices	√	√	N/A	N/A	N/A
3. EDP Functions segregated from users	N/A	√	N/A	√	√
4. Sales and accounts receivable postings are reconciled	N/A	√	N/A	√	√
5. Billing function segregated from collection function	N/A	√	N/A	√	√
6. Recording of sales journal and subsidiary ledger segregated	N/A	N/A	N/A	√	√
7. Monthly statements sent to customers	√	√	N/A	N/A	N/A
8. Invoices are reviewed and verified	N/A	√	N/A	N/A	N/A
Initial Assessment of Control Risk	Moderate	Low	N/A	Moderate	Moderate
Tests of Controls——W/P Ref.					
Final Assessment of Control Risk					

CHAPTER 14

Roundup of Auditing Standards Board Pronouncements and Other Auditing Matters

CHAPTER 14
Roundup of Auditing Standards Board Pronouncements and Other Auditing Matters

This chapter covers the pronouncements that have been issued within the last year and pronouncements that are currently under development not covered in other chapters. The discussion includes Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), Audit and Accounting Guides, Statements of Position (SOPs), Auditing Procedure Studies, professional ethics pronouncements, Auditing Interpretations, and notices to practitioners. Audit Risk Alerts and Current Industry Developments are addressed in Chapter 10 of this book.

Many of the items discussed are exposure drafts and pronouncements that are not yet issued. Why not wait to worry about them until *after* their effective dates? A professional needs to keep up with the emerging issues for many reasons, including:

- If the accountant objects to the proposed guidance, he or she has an opportunity to write a comment letter to improve the standards or guidelines before they are issued.
- Clients expect their accountants to stay on top of current issues. It is better to be aware of the upcoming accounting treatments and requirements to assist clients in making an easier transition. Establishing future required policy is often easier than applying an optional accounting policy one year, and having to change it the next. Also, clients appreciate advance warning about changes that will affect their statements.
- It helps the accountant to plan the best use of Continuing Professional Education (CPE) hours.
- Knowing in advance any pronouncements that will affect audit time, cost, scheduling, etc., helps the accountant estimate fees, permits advance notice to the client of any additional information-gathering required, and, in general, makes the engagements run more smoothly and fee collection easier.

The information presented is the best available at the time of preparation of this book, but bear in mind that the status of the proejcts may have changed by the time of printing.

STATEMENTS ON AUDITING STANDARDS

Three new SASs are expected to be issued by the end of 1990:

- *Consideration of the Internal Audit Function in an Audit of Financial Statements*
- *Omnibus Statement—1990*
- *Communication of Matters About Interim Financial Information Filed or to Be Filed with Specified Regulatory Agencies*

In addition, the following new exposure drafts of proposed SASs are expected to be issued:

- *Use of Confirmations*
- Revision of SAS No. 36, *Review of Interim Financial Information*
- Revision of SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*
- Revision of SAS No. 49, *Letters for Underwriters*
- Amendment of SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*
- Revision of SAS No. 5, *GAAP Hierarchy*

Each of these new or proposed SASs is discussed below.

Consideration of Internal Audit

Background and Definitions

In early 1990, the Auditing Standards Board issued an exposure draft of a new SAS entitled, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. Once adopted, the new SAS will supersede SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit*. The statement is expected to be issued in November 1990.

An *internal audit function* may consist of one or more individuals who perform internal auditing activities within an entity. Note, however, that the statement is not applicable to personnel with the title *internal auditor* who do not perform internal audit activities as described in the statement.

Requirements

As part of obtaining an understanding of the internal control structure, the auditor should obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit. *Relevant activities* are those that provide evidence about the design and effectiveness of policies and procedures that pertain to the entity's ability to record, process, summarize, and report financial data. (For example, internal audit activities that are *not* relevant include procedures to test the efficiency of management decision-making processes.) The extent of procedures necessary to obtain the understanding varies based on the circumstances.

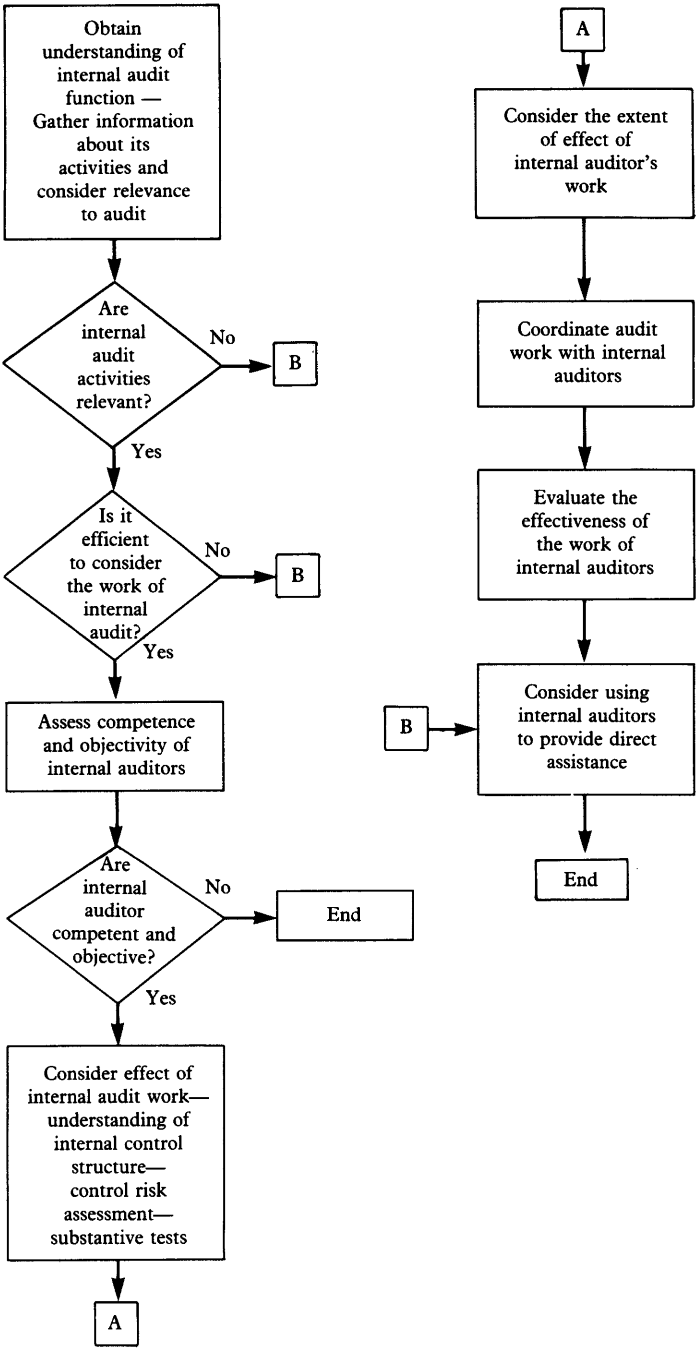
If, after obtaining an understanding of the internal audit function, the auditor concludes that the internal auditors' activities are not relevant to the financial statement audit, the auditor does not have to give further consideration to the function. Even if some internal audit activities are relevant to the audit, the auditor is still permitted to conclude that it would not be an efficient audit approach to further consider the work of the internal auditors.

Additional consideration of how the internal auditors' work might affect the nature, timing, and extent of audit procedures may be an efficient approach, for example, if the internal auditors have already performed procedures that the auditor would have to reperform. If the auditor decides further consideration is efficient, the auditor should assess the competence and objectivity of the internal audit function in light of the intended effect of the internal auditors' work on the audit. The auditor should perform procedures to evaluate the quality and effectiveness of the internal auditors' work that significantly affects the nature, timing, and extent of the auditor's procedures.

In addition, the auditor may request direct assistance from the internal auditors in performing the audit. When direct assistance is provided, the auditor should consider the internal auditors' competence and objectivity and should supervise, review, evaluate, and test their work.

Exhibit 14-1 is a flow chart of the process of the auditor's consideration of the internal audit function.

Exhibit 14-1


Obtain understanding of internal audit function — Gather information about its activities and consider relevance to audit
Are internal audit activities relevant?
No
B
Yes
Is it efficient to consider the work of internal audit?
No
B
Yes
Assess competence and objectivity of internal auditors
Are internal auditor competent and objective?
No
End
Yes
Consider effect of internal audit work—understanding of internal control structure—control risk assessment—substantive tests
A
A
Consider the extent of effect of internal auditor's work
Coordinate audit work with internal auditors
Evaluate the effectiveness of the work of internal auditors
B
Consider using internal auditors to provide direct assistance
End

Procedures to Obtain an Understanding

The auditor should ordinarily make inquiries regarding—

- Standing within the entity.
- Activities.
- Use of professional standards.
- Audit plan, including the nature, timing and extent of audit work.
- Access to records and whether there are limitations on the scope of activities.

The inquiries are ordinarily directed to management and to internal audit personnel. Also, information about goals and objectives may be available in an internal audit charter, mission statement, or similar directive.

Procedures to Assess the Competence and Objectivity of the Internal Auditors

These procedures are needed when the auditor has decided that further consideration is an efficient approach and the internal auditors' work may affect the nature, timing and extent of the audit. The auditor should obtain (or update information about competence from prior years)—(1) educational level and professional experience, (2) professional certification and continuing education, (3) evaluation of internal auditors' performance, (4) practices regarding assigning of internal auditors, and (5) audit policies, procedures, and checklists.

The auditor should obtain or update information about factors related to objectivity such as the organizational status of the internal auditor and the policies to maintain the objectivity of internal auditors about the areas audited. The organizational status is indicated by such questions as the following:

- Does the internal auditor report to an officer of sufficient status to ensure broad audit coverage and action on findings?
- Does the internal auditor have direct access to the board of directors, audit committee, or owner-manager? Does he or she report regularly to them?
- Does the board of directors, audit committee, or owner-manager oversee employment decisions related to the internal auditor?

The policies to maintain objectivity of internal auditors include—

- Prohibiting internal auditors from participating in audit areas where relatives are employed in important or audit-sensitive positions.
- Prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the internal audit function.

Potential sources of this information include previous experience with client, discussion with management, and reading a recent external quality review report.

Criteria for assessment may include professional internal auditing standards, such as standards issued by the Institute of Internal Auditors and the General Accounting Office.

Procedures to Evaluate the Effectiveness of the Internal Auditor's Work

The nature and extent of these procedures are matters for the independent auditor's judgment. The auditor should consider the following questions in developing the procedures:

- Is the scope of internal auditors' work appropriate to meet the auditor's objectives?
- Do working papers adequately document work performed?
- Are the conclusions reached appropriate in the circumstances?
- Are reports consistent with the results of the work performed?

The auditor should test some of the internal auditors' work related to the significant assertions at the financial statement level by either examining some of the controls, transactions, or balances that the internal auditors examined and comparing results, or by examining similar controls, transactions, or balances not actually examined by the internal auditors, and comparing results.

Exhibit 14-2 presents a checklist for evaluating the internal audit function. It is taken from a joint study of the AICPA and the Canadian Institute of Chartered Accountants and is adapted from Wanda A. Wallace's *Handbook of Internal Accounting Controls*.

Exhibit 14-2 ***Checklist for Evaluating the Internal Audit Function***

Objectivity of the Internal Audit Department	*Yes*	*No*	*Comments*
1. Is the organizational status of the director of internal audit sufficient to provide reasonable assurance that the internal auditors can independently audit the organization's activities?			
2. Is concurrence of the audit committee required to hire and dismiss the director of internal audit?			
3. Are the reports free of censorship by management?			
4. Does the director of internal audit have access to the audit committee without management's presence?			
5. Does the internal audit department have full access to the entity's operations and records?			
6. Does management adequately support the internal audit department?			
7. Are temporary assignments of internal audit staff to line or accounting functions prohibited?			
8. Are professional staff periodically rotated on audit assignments?			
9. Is consideration given to potential independence conflicts when scheduling individual internal auditors to audit assignments?			
10. Are findings in audit working papers consistent with the content of the internal auditors' reports?			
Competence of the Internal Audit Department			
11. Does the internal audit department have minimum education and experience requirements?			
12. Are education and business and auditing experience of the internal auditors commensurate with their responsibilities?			
13. Does a sufficient number of the internal audit staff hold relevant professional certificates?			

Exhibit 14-2 ***(cont.)***

Competence of the Internal Audit Department	*Yes*	*No*	*Comments*
14. Does the internal audit department encourage staff to obtain relevant professional certificates?			
15. Do internal auditors engage in sufficient continuing education?			
16. Is there long-range planning of audit assignments based on qualifications of the internal auditors?			
Supervision of Internal Auditors			
17. Are job descriptions formalized?			
18. Are relevant audit manuals available for use by the internal auditors?			
19. Is there adequate planning of audit assignments, including approval of programs by supervisory personnel?			
20. Do staff members receive adequate supervision throughout audit assignments?			
21. Are there adequate policies for review of audit working papers?			
22. Are periodic performance reviews of staff required?			
Internal Audit Work Performance			
23. Are audit programs adequate?			
24. Do the audit working papers indicate adequate performance of work?			
25. Are the findings and recommendations of the audit reviewed with management on a higher level than the head of the audited department?			
26. Is there a follow-up on findings of audit reports with emphasis on the corrective action taken by affected areas?			
27. Based on experience with the internal auditors, does their work performance appear to be adequate?			

SOURCE: Adapted from Wanda A. Wallace, *Handbook of Internal Accounting Controls* (Englewood Cliffs, N.J.: Prentice-Hall, Inc, 1984).

Effect of Internal Auditors' Work on the Audit Plan

The internal auditors' work may have several effects on the auditor's procedures to obtain an understanding of the internal control structure. The auditor may use the internal audit work, such as flowcharts and narratives, to obtain information about internal control structure policies and procedures. Also, the results of internal audit procedures may provide information about whether the policies and procedures have been placed in operation.

The internal auditors' work also may affect procedures to assess control risk. The internal audit function may influence the overall assessment of the risk of material misstatement the financial statement level. In assessing control risk at the account balance or class of transactions level, the auditor may consider the results of procedures performed by the internal auditors.

The effect on substantive procedures is that the internal auditors' procedures may provide direct evidence about material misstatements in specific assertions. For example, they may confirm certain accounts receivable or observe inventories, or the internal auditors may perform work at a variety of locations, thus reducing the number of locations the auditor must visit.

Extent of Effect

The internal auditors' work may affect the auditor's procedures, but the auditor should still perform sufficient procedures to obtain evidential matter to support the audit report. The ultimate responsibility for both the audit and the audit report remain solely the auditor's. It is *not* similar to the situation when the auditor uses the work of other independent auditors.

For assertions where inherent risk of material misstatement is low and the internal audit work results are persuasive, the auditor may decide that additional testing is not needed. Examples of this type of assertion are those related to fixed asset additions or deposit accounts at banks.

For assertions where inherent risk of material misstatement is high, such as those related to uncertainties, related party transactions, contingencies, subsequent events, and significant accounting estimates, the auditor's assessment of control risk and the results of internal audit work cannot alone reduce audit risk to an acceptable level.

Assertions that require more subjective judgment in evaluating evidence are more likely to need audit evidence obtained directly by the auditor. For example, the existence assertion tends to have a more objective evaluation, whereas the valuation and disclosure assertions tend to require more subjective evaluation of audit evidence.

Omnibus Statement on Auditing Standards—1990

This exposure draft contains amendments to three SASs (SAS Nos. 1, 58, and 59). The SAS is expected to be issued by October 1990.

The most significant change to the existing literature is the proposed amendment to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. This amendment addresses a problem that has occurred in practice: explanatory paragraphs in which it is unclear whether the auditor is saying there is a going-concern problem. The amendment provides required language that the auditor should include in an explanatory paragraph in the report when he or she concludes that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year from the balance-sheet date. The terms *substantial doubt* and *going concern* are required. Exhibit 14-3 illustrates an explanatory paragraph that meets these requirements. Although this SAS is not expected to be issued in final form until the last quarter of 1990, the Securities and Exchange Commission (SEC) staff has stated that they believe auditors should currently be including these terms in the explanatory paragraphs in current SEC filings.

Exhibit 14-3 ***Example Explanatory Paragraph Going-Concern Uncertainty***

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubt abouts its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

The Omnibus SAS also replaces use of the term *review* in certain audit reports in which the language might be mistaken for a review of financial statements under Statements on Standards for Accounting and Review Services (SSARS). Specifically, the SAS—

- Changes the explanatory language in the auditor's report for the successor auditor when the prior-year financial statements audited are restated and the predecessor auditor's report is not presented. Exhibit 14-4 illustrates such a report. The SAS also replaces the phrase, "We also reviewed the adjustments" with the phrase, "We also audited the adjustments."
- Modifies the reporting guidance for the auditor who, following a pooling-of-interests transaction, is asked to report on the combination of restated financial statements when other auditors have audited one or more of the entities included. The SAS also replaces the phrase, "We have also applied procedures to the combination" with the phrase, "We have also audited the combination."

Exhibit 14-4 ***Successor Auditor's Report When Predecessor Auditor's Report is Not Presented***

Independent Auditor's Report

We have audited the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1 were audited by other auditors whose report, dated March 31, 19X2, expressed an unqualified opinion on those statements.

[Same second paragraph as the standard report]

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Communication of Matters About Interim Financial Information Filed or to Be Filed with Specified Regulatory Agencies

The proposed SAS requires communication with management, and in certain instances, communication with the audit committee about matters affecting interim financial information filed or to be filed with specified regulatory agencies. Issuance of the final SAS is expected in October 1990.

The proposed statement is applicable when, as a result of devoting *substantive attention* to a matter, the auditor believes that interim financial information filed with or to be filed with the SEC or another specified regulatory agency is *probably materially misstated.*

Examples of substantive attention include (1) consulting with the entity on the application on the of generally accepted accounting principles (GAAP) to specific significant events or transactions, (2) performing procedures on interim financial information, including procedures for a review in accordance with SAS No. 36, *Review of Interim Financial Information,* or (3) performing procedures for the audit of the annual financial statements, including consideration of the effects of year-end adjustments that are material to the results of the entity's fourth quarter. Giving preliminary consideration to a matter does not constitute substantive attention.

The action to be taken by the auditor is to communicate the matters, either orally or in written form, to the appropriate level of management as soon as practicable. If management does not respond appropriately, the auditor should inform the audit committee of the matters. If the audit committee does not respond appropriately within a reasonable period of time, the auditor should consider whether to remain as the entity's auditor and may wish to consult with his or her attorney.

Oral communications of these matters should be documented in the workpapers.

Expected Exposure Drafts

Use of Confirmations

The Auditing Standards Board expects to issue this exposure draft before the end of 1990. The proposed SAS includes a new standard bank confirmation form and illustrative confirmation letters for confirming other types of transactions with financial institutions, such as contingent liabilities, compensating balance arrangements, and letters of credit. The revised standard form to confirm information with financial institutions has been approved by the American Bankers Association and is pending approval by the Bank Administration Institute. The proposed SAS also contains comprehensive guidance on the use of all types of confirmations.

Revision of SAS No. 36, *Review of Interim Financial Information*

The Auditing Standards Board expects to issue an exposure draft amending SAS No. 36, *Review of Interim Financial Information,* in late 1990 or early 1991. The amended statement would provide additional guidance on the accountant's required knowledge level about client internal control structure when the most recent financial statements were not audited by the accountant (i.e., no audit base). The amendment would modify SAS No. 36 report to include a reference to management's responsibility for the interim financial information, and would eliminate the reference to the accountant's understanding of the system of preparation of interim financial information.

Revision of SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*

The proposed SAS provides guidance to auditors who report on the processing of transactions by a service organization to other auditors who report on the financial statements of user organizations.

Two reports are being considered: (1) one that expresses an opinion on a description of policies and procedures placed in operation at a service organization, and (2) one that expresses an opinion on a description of policies and procedures placed in operation and tests of operating effectiveness.

An exposure draft is expected by the end of 1990. However, a new task force is studying the effect of proposed legislation that would amend ERISA, and is considering the type of information that needs to be communicated to auditors of employee benefit plans about trustee organizations. The reports in the draft are being reviewed to determine whether they will accommodate this information.

Revision of SAS No. 49, *Letters for Underwriters*

SAS No. 49 was issued before the issuance of the attestation standards on financial forecasts and projections and on reporting on pro forma financial information. The revision updates SAS No. 49 for this new guidance and addresses several other changes, including guidance on letters to underwriters subject to Section 11 liability under the Securities Act of 1933. An exposure draft is expected before the end of 1990.

Amendment of SAS No. 63

The AICPA has received comments identifying the need for minor technical amendments to SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*. An exposure draft is expected before the end of 1990.

GAAP Hierarchy Amendments

The hierarchy of the standards and other literature that composes generally accepted accounting principles (GAAP) is set forth in SAS No. 5, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report*. Recently, the Financial Accounting Foundation Trustees determined that entities subject to the pronouncements of the Government Accounting Standards Board (GASB) state and local governments have a separate GAAP (generally accepted accounting principles) hierarchy than other entities. Currently, SAS No. 5 combines the Financial Accounting Standards Board (FASB) and GASB pronouncements into the same hierarchy, and revisions are being made to reflect the jurisdictional changes.

The exposure draft is also expected to clarify the preferability of levels within each hierarchy by stating, for example, that pronouncements in category b, such as audit guides, have preference over category c, which includes industry practice.

STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS (SSAEs)

The SEC has issued a proposal that would require public companies to assess the effectiveness of their internal control structure and report the results publicly. (See discussion in Chapter 13, "Internal Control Structure.") This proposal is expected to be adopted with little modification. Standards currently exist providing guidance when an auditor evaluates and reports on internal control structure. However, new guidance is needed for the situation in which management reports on the internal control structure and the practitioner issues a report on management assertions.

An initial draft of a proposed SSAE to address this type of engagement has been prepared and is currently under discussion by the Auditing Standards Board. The Board is considering alternative models for general-purpose reporting on an entity's internal control structure, determining the circumstances in which each of those models is appropriate for such reporting, and developing performance and reporting guidance under each of the appropriate models. SAS No. 55 is being used as a framework for developing the reporting guidance. The Board has tentatively concluded that a review-level service is not appropriate.

AUDIT AND ACCOUNTING GUIDES

The audit and accounting guide, *Consideration of the Internal Control Structure in a Financial Statement Audit,* was issued in mid-1990. It is covered in Chapter 13 of this book.

The other audit and accounting guide issued in final form in mid-1990 is *Audits of Providers of Health Care Services*. This guide is a revision of the existing *Hospice Audit Guide* and related SOPs. It applies not only to hospitals, but also to nursing homes, Health Maintenance Organizations (HMOs), continuing care retirement communities, physician group practices that issue financial statements in accordance with GAAP, and ambulatory care facilities.

The following audit and accounting guides are currently under development by the AICPA Auditing Standards Division or Accounting Standards Division. If any of these topics affect your clients, you may wish to request a copy of the relevant exposure draft.

Exposure Drafts Issued

Exposure drafts of the following audit and accounting guides have been issued and are available from the AICPA Order Department.

Common Interest Realty Associations

An exposure draft of this proposed guide was issued in August 1988, and it has been revised for the comments received. The proposed guide has been sent to the FASB for review. The timing of the final guide's issuance is uncertain because the position on accounting for common property in the revised draft differs from the position taken by the FASB. The proposed guide provides guidance on the following matters:

- Financial reporting of common property and facilities, including the effects of the manner in which the assets were acquired, and depreciation policies
- Major repairs and replacements (for example, disclosure of designated funds for future major repairs and supplementary disclosures of anticipated major repairs and property replacements)
- Financial reporting (formats and illustrative statements)
- Method of accounting, including a discussion of when accrual basis is needed and when the cash basis may be used
- Budgets, the basis for members' assessments
- Income tax guidelines for determining tax filing alternatives
- Audit considerations
- Review and compilation engagements
- Cooperative housing corporations and issues unique to those entities

Property and Liability Insurance Companies

This project is a revision of the 1966 *Audits of Fire and Casualty Insurance Companies* guide. The exposure period is over and the draft has been revised. The FASB, GASB, and Accounting Standards Executive Committee (AcSEC) have approved issuance. The final guide is expected to be issued in the third quarter of 1990.

Audits of Federal Government Contractors

The revision of the existing audit guide has been approved for issuance by both AcSEC and the FASB. The final guide is expected to be issued in fourth quarter, 1990.

Audit and Accounting Guides Under Development

The following projects are currently underway. Their status is briefly covered, and the anticipated date of issuance of the exposure draft is provided.

Insurance Agents and Brokers. This project is to develop an entirely new guide that addresses accounting by insurance agents and brokers. The proposed guide was approved for exposure by the

FASB, pending resolution of certain points. The exposure draft is expected to be issued in the fourth quarter of 1990.

Audits of Futures Commission Merchants and Commodity Pools. This project is to develop a new audit and accounting guide in this area. The exposure draft is expected to be issued by the end of 1990.

Not-for-Profit Audit Guide Revision. This project, to update the existing guide, is in the initial drafting phase. An exposure draft is not expected until late 1992. The not-for-profit organizations addressed will include colleges and universities, voluntary health and welfare organizations, and certain other not-for-profit organizations. Thus, it is expected that the new guide will eliminate existing inconsistencies in accounting and financial reporting by these organizations.

Audits of Employee Benefit Plans. The committee has prepared a summary of proposed revisions of the existing 1983 audit guide. An exposure draft is expected in the fourth quarter of 1990.

Audits of State and Local Governmental Units. The task force is currently preparing an initial draft of the revision of the existing guide. Exposure is expected in the second quarter of 1991.

Audit Sampling. The project to update the existing guide has just begun. The revised guide will use the new terminology of SAS No. 55 and other expectation gap SASs and will provide better how-to guidance for applying SAS No. 39, *Audit Sampling.* A revised draft of the guide is expected to be completed in 1991.

Audits of Credit Unions. The current guide is being updated. One area under consideration is whether investments in debt securities should be accounted for at cost, marked to market value, or recorded at the lower of cost or market. No anticipated exposure date has yet been set.

Savings Institutions Guide. This proposed guide will supersede the 1979 guide. It is expected to be exposed for public comment in September 1990.

In addition, many audit guides contain example reports and reporting guidance that was issued before SAS No. 58, *Reports on*

Audited Financial Statements, and SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit.* Work is proceeding to update this guidance in the existing guides.

NEW SOPs AND SOPs UNDER DEVELOPMENT

New SOPs

The following SOPs have been issued.

SOP 89-1, *Reports on Audited Financial Statements of Brokers and Dealers in Securities*

SOP 89-1 amends the AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities,* issued in 1985. The amendments change the form of the auditor's reports illustrated in the guide to conform with SAS No. 58 on reports on audited financial statements. The new reports illustrated in the SOP include—

- An unqualified opinion.
- GAAP departure—unsupportable valuation.
- Explanatory paragraph for uncertainty of valuation.
- Separate report on supplementary schedules.

SOP 89-1 is currently effective.

SOP 89-2, *Reports on Audited Financial Statements of Investment Companies*

SOP 89-2 amends the AICPA Audit and Accounting Guide, *Audits of Investment Companies,* issued in 1987. The amendments change the form of the auditor's reports illustrated in the guide to conform with SAS No. 58 on reports on audited financial statements. The new reports illustrated in the SOP include—

- An unqualified opinion.
- A multicolumnar presentation of portfolios constituting the series for a series fund.
- A presentation of one of the portfolios or entities constituting the series.
- An explanatory paragraph when the financial statements contain securities whose values were estimated by the board of

directors in the absence of readily ascertainable market values, and the range of possible values of those securities is significant.

- A qualified opinion when the auditor concludes that the valuation procedures are inadequate or unreasonable, or that the underlying documentation does not support the valuation.

SOP 89-2 is currently effective.

SOP 89-3, *Questions Concerning Accountants' Services on Prospective Financial Statements*

SOP 89-3 is a supplement to the AICPA *Guide for Prospective Financial Statements.* It was prepared to provide guidance in areas for which questions had been raised by practitioners. The specific areas addressed are—

- Reporting on financial forecasts that include a projected sale of an entity's real estate investment.
- Sales prices assumed when a financial forecast includes a projected sale of an entity's real estate investment.
- Reporting on information accompanying a financial forecast in an accountant-submitted document.
- Financial projections included in general-use documents.
- Support for tax assumptions.
- Periods covered by an accountant's report on prospective financial statements.

SOP 89-3 is currently effective.

SOP 89-4, *Reports on the Internal Control Structure in Audits of Brokers and Dealers in Securities*

SOP 89-4 amends the AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities,* issued in 1985. The amendments change the guidance on the reports on the internal control structure to conform with SAS No. 60, on communication of internal control structure related matters noted in an audit. The new reports illustrated are—

- Report on the internal control structure required by SEC Rule 17a-5.
- Report when the broker or dealer has not made the required

notification or when the auditor does not agree with the statements therein.

The SOP is effective for audits of financial statements for periods beginning on or after January 1, 1989.

SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*

Health maintenance organizations (HMOs) are the most common form of organization providing prepaid health care services. The SOP provides guidance on applying GAAP for HMOs and other providers of prepaid health care services. In summary, the SOP provides recommendations regarding—

- When to accrue health care costs. Health care costs should be accrued as the services are rendered. Additional guidance is provided for special situations, such as when a provider is obligated to render services to members beyond the premium period due to provisions in the contract or other requirements.
- When to recognize contract losses (premium deficiencies). A loss should be recognized when it is probable that expected future costs under a group of existing contracts will exceed anticipated future premiums and stop-loss insurance recoveries.
- Accounting for stop-loss insurance (reinsurance). Stop-loss insurance premiums should be included in reported health care costs.
- Accounting for contract acquisition costs. Contract acquisition costs should be expensed as incurred.

SOP 89-5 is effective for fiscal years beginning on or after June 15, 1989.

SOP 89-6, *Auditors' Reports in Audits of State and Local Governmental Units*

SOP 89-6 amends the AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units,* issued in 1986. The changes to the guide are needed because of the subsequent issuance of two SASs—SAS No. 58 on reports on audited financial statements, and SAS No. 63 on compliance auditing applicable to governmental entities and recipients of governmental financial assistance. Note that other entities, such as not-for-profits that receive financial assistance from a governmental unit, are also affected by this SOP and SAS No. 63.

The SOP illustrates twenty-six sample auditors' reports. Some report examples were effective at the time of issuance of the SOP, and others are effective for fiscal periods beginning on or after January 1, 1989. Examples of the reports included are—

- Unqualified and qualified opinions on general-purpose or component unit financial statements, and explanatory paragraphs for a variety of situation
- Compliance report
- Unqualified, qualified, adverse, and disclaimer of single audit opinions on compliance with specific requirements applicable to major federal financial assistance programs
- Report on internal control structure in accordance with Government Auditing Standards

SOP 89-7, *Audits of Investment Companies (Reports on Internal Control Structure)*

SOP 89-7 amends the AICPA Audit and Accounting Guide, *Audits of Investment Companies*. It updates the illustrations of reports on internal control structure for the changes required by SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit.*

SOP 90-1, *Accountant's Services on Prospective Financial Statements for Internal Use Only and Partial Presentations*

SOP 90-1 is covered in Chapter 12 of this book.

SOP 90-2, *Reports on Internal Control Structure in Audits of Futures Commission Merchants*

SOP 90-2 amends the AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities*. It updates the illustration of the independent auditor's report on the internal control structure required by Commodity Futures Trading Commission Regulation 1.16, for the changes required by SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit.* The statement is effective for reports issued on or after March 1, 1990.

SOP 90-3, *Definition of the Term "Substantially the Same" for Holders of Debt Instruments, as Used in Certain Audit Guides and an SOP*

The pronouncements affected include the *Audits of Banks,* SOP 85-2 on *Accounting for Dollar Repurchase—Dollar Reverse Repurchase Agreements by Sellers-Borrowers* (which amends the *Savings and Loan Associations Guide*), and *Audits of Brokers and Dealers in Securities.* SOP 90-3 provides guidance for determining whether two debt instruments are substantially the same for the purpose of determining whether a transaction involving a sale and purchase or an exchange of debt instruments should be accounted for as a sale or as a financing. The SOP lists six criteria, all of which must be met for two debt instruments to be considered substantially the same. The SOP applies to transactions entered into after March 31, 1990.

SOP 90-4, *Auditor's Reports Under U.S. Department of Housing and Urban Development's "Audit Guide for Mortgagors Having HUD Insured or Secretary Held Multifamily Mortgages"*

SOP 90-4 illustrates auditors' reports on financial statements, on compliance with laws and regulations, and on the internal control structure that satisfy the requirements of HUD's *Audit Guide,* and of SAS Nos. 58, 60, and 63. The SOP is effective for reports issued on or after April 1, 1990.

SOP Exposure Drafts Issued

The exposure drafts of these SOPs are available from the AICPA order department. Each project is described briefly, together with the anticipated date for issuance of an SOP in final form.

Director's Examination of Banks. This proposed SOP clarifies the scope of the auditor's examination when conducting a bank director's examination. The draft has been revised based on comments received during exposure, and the final SOP is expected to be issued before the end of 1990.

Inquiries of Representatives of Financial Institution Regulatory Agencies. This exposure draft of a proposed SOP amends the *Bank Audit Guide* and the *Savings and Loan Audit and Accounting Guide* and has been expanded to address the audits of credit unions. The SOP is expected to be issued in final form before the end of 1990.

Accounting by Continuing-Care Retirement Communities. This project is intended to provide guidance on accounting for the obligation to provide services and the use of facilities, and accounting for initial direct costs of acquiring contracts. An exposure draft was issued and the SOP revised for comments received. The final SOP is expected to be issued in the first quarter of 1991, after FASB review and clearance.

Accounting for Frequent Travel Award Programs. The SOP was exposed and has been cleared for final issuance by AcSEC. The final SOP is expected to be issued in the fourth quarter of 1990, after clearance by the FASB.

Financial Reporting by Entities in Reorganization Under the Bankruptcy Code. The exposure draft was issued in April 1990. The draft is being revised for comments received. A final SOP is expected to be issued by the end of 1990.

Reporting by Financial Institutions of Debt Securities Held as Assets. The exposure draft was issued in May 1990, and comment letters are currently being analyzed. A revised draft is being prepared, and issuance of the final SOP is expected in 1991.

SOPs Under Development

The following SOPs are currently under development by the AICPA Accounting Standards Division. If the topic affects your clients, you may wish to request a copy of the exposure draft when it becomes available from the AICPA order department.

Software Revenue Recognition. The Task Force on Accounting for the Development and Sale of Computer Software has submitted a proposed exposure draft to AcSEC and the FASB for discussion. Issuance of the exposure draft is expected by the end of 1990.

Employee Stock Ownership Plans (ESOPs). This project addresses issues related to employer's reporting of transactions involving ESOPs. The project is still in the initial development stage. An exposure draft is not expected until the fourth quarter of 1991.

Accounting for Foreign Property and Liability Reinsurance Contracts. This project was originated because of an SEC request for the AICPA to provide guidance on reinsurance auditing and accounting issues. The task force's draft is being reviewed and revised. An exposure draft is expected in the fourth quarter of 1991.

Guidance for Assessing Risk Transfers in Property and Liability Reinsurance Contracts. The task force is revising its initial draft. An exposure draft is expected in the fourth quarter, 1990.

Financial Reporting of Interest Income. A prospectus for the project has been sent to the FASB for comments, and a survey of practice is in process. An initial draft is expected to be ready for committee discussion in the first quarter of 1991.

Applicability of Accounting Research Bulletins (ARBs), Accounting Principles Board (APB) Opinions, and FASB Statements to Not-for-Profit Organizations. This proposed SOP addresses the applicability of the Rule 203 pronouncements to not-for-profit organizations. A revised draft of the SOP exposure draft has been prepared. An exposure draft is expected in the first half of 1991.

Consolidations and Combinations Involving Not-for-Profit Organizations. The draft of the proposed SOP is being revised. An exposure draft is expected to be issued in the first half of 1991.

Financial Reporting by Partnerships. This project was begun in 1987 to address financial reporting by general and limited partnerships. The prospectus has been approved, and the initial draft is being written. An exposure draft is not expected until late 1991.

Current Value Reporting by Real Estate Companies. This project is designed to help ensure that auditors' reports on supplemental current value information will be consistent. The project has been outlined, and a draft is being prepared. An exposure draft is anticipated in 1992.

Reporting by Participating Mortgage Loan Borrowers. The Real Estate Committee is converting a draft issues paper into an SOP. The draft SOP has been presented to AcSEC for initial discussion. Issuance of the exposure draft is expected in late 1991 or early 1992.

Accounting for Real Estate Syndication Activities. The draft, which addresses accounting for real estate syndication fees, has been reviewed by AcSEC and the FASB. It is being revised for their comments. The exposure draft is expected to be issued in the third quarter of 1990.

Reporting on Advertising Activities. The discussion draft is being revised based on AcSEC comments. The proposed SOP addresses accounting for advertising costs and for certain other activities undertaken to create intangible assets. An exposure draft is not expected until 1992.

Single Audit and Related Compliance Auditing and Internal Control Review Issues. The task force is preparing an initial draft of an SOP to update and clarify certain issues in the existing *Audits of State and Local Governmental Units* audit guide. There is a project to revise the audit guide, but this proposed SOP will provide guidance while the more time-consuming project of revising the entire guide is in process. The committee plans to issue the exposure draft in the fourth quarter of 1990.

Accounting for Foreclosed Assets. AcSEC has approved the proposed SOP for exposure, subject to clearance of suggested changes. The exposure draft should be available before the end of 1990.

AUDITING PROCEDURE STUDIES

Several auditing procedure studies are currently under development by the Auditing Standards Division.

Audits of Small Businesses. This study is being revised to reflect the new terminology and requirements of SAS Nos. 53 through 62. Key changes are in the chapters on evaluating internal controls and on performing analytical procedures to discuss the implementation of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* and SAS No. 56, *Analytical Procedures.* The revised study is expected to be available before the end of 1990.

Auditing Insurance Entities' Loss Reserves. A project has begun to prepare an auditing procedure study to provide guidance to auditors in developing an effective audit approach when auditing claim loss reserves of insurance companies. The anticipated completion date has not yet been set.

Computer Auditing. The Computer Auditing Subcommittee is drafting three auditing procedure studies. The first describes how SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* can be implemented in a computer environment. This study is expected to be available in the third quarter of 1990. The second study updates the guidance in the existing audit and accounting guide, *Computer Assisted Audit Techniques.* The third auditing procedure study addresses the possible effects of advanced EDP systems on the auditor's consideration of an entity's internal control structure. The second and third studies are expected to be available in 1991.

PROFESSIONAL ETHICS PRONOUNCEMENTS

The Professional Ethics Executive Committee has issued two omnibus exposure drafts. The first, issued May 22, 1990, contained seven proposals; and the second, issued July 23, 1990, contained eight.

May 1990 Exposure Draft—Omnibus Proposal of Professional Ethics Division Interpretations and Rulings

The Meaning of Certain Independence Terminology and the Effect of Family Relationships on Independence. This is a revision of interpretation 101-9 under Rule 101. The changes to this interpretation include (1) a revised definition of a member or a member's firm, which includes contractors and entities controlled by persons included in the firm; (2) deletion of reference to key assistants to certain financial executives as positions with a client indicating significant influence; (3) a new section defining the phrase "office participating in a significant portion of the engagement"; (4) inclusion of specific time periods during which relationships of the auditor's nondependent close relatives cause independence impairments; and (5) reference to cohabitants as having a relationship that may cause an independence impairment.

Member on Board of Directors of Federated Fund-Raising Organization. This is a revision of Ethics Ruling No. 14 under Rule 101. The change recognizes that a member's service on the board of a federated fund-raising organization could impair the member's independence with respect to recipients of the funds distributed by that organization. Specifically, independence would be impaired if the fund-raising organization can affect the management decisions of the recipient organization.

Member as Auditor of Insurance Company. This is a revision of Ethics Ruling No. 41 under Rule 101. A member's independence would not be considered impaired with respect to an insurance company that receives, holds in a pooled separate account, and invests contributions with respect to the member's retirement plan. This change eliminates the reference to the materiality of the member's retirement plan funds in relation to the net worth of the insurance company.

Past-Due Billings: Client in Bankruptcy. This proposal deletes Ethics Ruling No. 45 under Rule 101. The topic is covered in other proposed pronouncements.

Past-Due Fees. This is a revision of Ethics Ruling No. 52 under Rule 101. The ruling deals with the issue of the effect on an auditor's independence of unpaid fees. Independence is considered to be impaired if, when the report on the client's current year is issued, fees remain unpaid, whether billed or unbilled, for professional services provided more than one year prior to the date of the report. Such amounts assume the characteristics of a loan within the meaning of Rule 101. This ruling does not apply to fees outstanding from a client in bankruptcy.

Member Providing Appraisal, Valuation, or Actuarial Services. This is a revision of Ethics Ruling 54 under Rule 101. The old Ruling 54 addressed only actuarial services. The proposed ruling adds appraisal and valuation services and states that "performance by a member of appraisal, valuation, or actuarial services, the results of which may be incorporated in the client's financial statements, would not impair a member's independence if all of the significant matters of the judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results of those services."

Deletion of the Definition of the Term "Engagement" as Used in Rule 201. The proposal would delete Interpretation 201-4 under Rule 201. Interpretation 201-4 was originally needed to make the attestation standards and certain other standards enforceable under Rule 201. The interpretation is no longer needed because the new Code of Professional Conduct includes such standards.

July 1990 Exposure Draft—Omnibus Proposal of Professional Ethics Division Interpretations and Rulings

Member Joining Client Credit Union. This proposal would be a new ethics ruling under Rule 101. Independence would be considered to be impaired unless—

- The credit union meets the definition of a financial institution ("as part of its normal business operations, makes loans to the general public") And...
- Any loans must be made under normal lending procedures, terms, and requirements.

The proposed interpretation specifies that a credit union that does not make its services available to everyone who lives and/or works in a broad geographic area (such as state, county, or city) would not qualify.

Member as Guarantor of Client's Loan. This would be a new ruling under Rule 101. The proposed ruling indicates that the member's guarantee of a client's loan is the equivalent of a loan to the client. If the guarantee exists during the period of the professional engagement or at the time of expressing an opinion, independence would be considered to be impaired.

Individual Considering or Accepting Employment with the Client. This proposed new ruling under Rule 102 would require that a member remove himself or herself from the engagement in situations in which client employment is being offered or sought until the offer is rejected or employment is no longer sought. The proposed ruling also warns the individual's firm of its responsibilities to ensure that all work had been performed with objectivity and integrity if the firm becomes aware that the individual failed to remove himself or herself from the engagement. The additional procedures required to obtain that assurance depend on the engagement and the individual's role in it.

Service on Board of Tax Appeals. This proposed ruling under Rule 102 would not prohibit the member from serving on a board of tax appeals established under a municipal income tax ordinance and at the same time providing tax or other professional services to a client or employer who comes before the board. However, the member must disclose this situation to the client or employer, the board, and any other appropriate parties and receive consent from all parties with respect to matters involving the client or employer.

Retention of Client's Records. This proposal revises Interpretation 501-1 under Rule 501. The old interpretation prohibited a member from retaining certain workpapers to enforce fee payment, if the specified workpapers contained data which should properly be reflected in the client's books and records, retention of which made those records incomplete. The proposed interpretation indicates that a member is *not* required to provide the workpapers or information contained therein if all fees due have not been paid. Information such as adjusting, closing, combining, or consolidating journal entries in the member's workpapers may be retained even if the client's financial information is incomplete. Client *records,* however, must be returned.

Financial Interests in Certain Organizations. This ruling reverses Ethics Ruling 17 under Rule 101. The ruling addresses membership in an organization (such as a country club or health club) in which membership requirements involve owning equity or debt securities. Under the old ruling, the member's independence was not considered impaired with respect to the club. Under the proposed ruling, the member's independence would be considered impaired because of the direct financial interest in the organization.

Member as Auditor of Common Trust Funds. This proposal would delete Ethics Ruling 34 under Rule 101, which deals with the question of the independence of an auditor of a common trust fund having an immaterial financial equity interest in the bank or a revolving loan with the bank. The deletion is proposed because the common trust funds of a bank are not part of the financial statements with respect to which the audit is being performed.

Member as Auditor of Mutual Fund and Shareholder of Investment Advisor/Manager. This proposal deletes Ethics Ruling 47 under Rule 101 because virtually all mutual funds are subject to the jurisdiction of the Securities and Exchange Commission (SEC), whose rules on auditor independence differ from AICPA rules.

RECENT INTERPRETATIONS

SSARS Interpretations

"Plain Paper" Interpretations

Three interpretations of Statements on Standards for Accounting and Review Services (SSARS) were issued and published in the September 1990 issue of the *Journal of Accountancy*. They are entitled:

- "Differentiating a Financial Statement Presentation from a Trial Balance"
- "Determining if the Accountant Has 'Submitted' Financial Statements Even When Not Engaged to Compile or Review Financial Statements"
- "Submitting Draft Financial Statements"

These interpretations are described in detail in Chapter 9 of this book, "Compilation Services."

Special-Purpose Financial Statements

A fourth interpretation of SSARS was also published in the September 1990 issue of the *Journal of Accountancy*. It provides guidance for reporting on special-purpose financial statements prepared in accordance with a basis of presentation specified in a contractual agreement or regulatory provision. Essentially, it adapts the reporting guidance of SAS No. 62 for these situations to a compilation or review engagement.

Interpretations of Statement on Standards for Attestation Engagements (SSAE)

Litigation Services

This series of interpretations, issued in July 1990, clarifies the type of litigation services that are exempt from the attestation standards. The attestation standards apply when the opposing party in litigation does not have the opportunity to challenge the findings (i.e., no cross) examination, or when the accountant is specifically engaged to provide a written report on the reliability of the representations of another party).

Reporting on Defense Industry Questionnaire on Business Ethics and Conduct—Questions 19 and 20

The interpretation provides guidance for independent accountants engaged to examine or review and to report on the responses to the Defense Industry Questionnaire on Business Ethics and Conduct. This interpretation provides illustrative procedures for the practitioner relating to questions 19 and 20. Illustrative procedures relating to questions 1 through 18 are provided in Appendix E Professional Standards of AU Section 2011.01 through 2011.27. Practitioners engaged to examine or review the responses to the Questionnaire should refer to the interpretation, which contains the procedures to be considered when performing such engagements.

Audit Interpretations

Current Value

This is an interpretation of SAS No. 62, *Special Reports*. It provides guidance to an auditor engaged to report on current-value financial statements that supplement historical cost financial statements in a general-use presentation of a real estate entity. It was issued in July 1990. The current-value basis is not an other comprehensive basis of accounting (OCBOA), but the auditor can report on the presentation in the same manner as on OCBOA financial statements, but only when the presentation accompanies historical financial statements. The interpretation illustrates suitable report language.

Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments

This is an interpretation of Professional Standards AU Section 337. The American Bar Association's Subcommittee on Audit Inquiry Responses has issued a report to clarify the relationship between (a) an auditor's inquiries concerning litigation, claims, and assessments and (b) the attorney-client privilege and the attorney work-product privilege. The existing policy is that neither the client's request to the attorney to provide information to the auditor nor the lawyer's response constitute an expression of intent to waive the privileges. Neither the ABA Subcommittee Report nor the AICPA Interpretation changes the existing policy.

Some clients and their attorneys have added language explicitly stating that they do not intend to waive the privileges. An example of such language in an audit inquiry letter is as follows:

> We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

An example of a lawyer response letter follows:

> The Company has advised us that, by making the request set forth in its letter to us, the Company does not intend to waive the attorney-client privilege with respect to any information which the Company has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company.

The interpretation clarifies that the addition of such language or similar language in the audit inquiry letter to legal counsel or in the lawyer's response letter does not result in a limitation on the scope of the audit. Such explanatory language is not a limitation on the scope of the lawyer's response. It simply makes explicit what has been implicit in the letters—the underlying policy that an audit inquiry letter and the response are not intended to be a waiver of the privileges. *Not* including the explanatory language also would not constitute an expression of intent to waive the privileges.

Inclusion of the explanatory language is not a guarantee. A court may still find that a waiver occurred based on the facts in particular circumstances.

Reports on the Existence of Material Weaknesses

This interpretation of SAS No. 60 considers whether, in connection with an audit, the auditor may issue a written report on material weaknesses separate from the report on reportable conditions.

SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit,* permits the issuance of a report that states whether any of the reportable conditions are material weaknesses. SAS No. 60 does not preclude the auditor from issuing a separate report stating whether any material weaknesses were noted during the audit.

Reports on material weaknesses should include the following elements:

- An indication that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure
- The definition of a material weakness
- A statement that the communication is intended solely for the information and the use of the audit committee, management, and others within the organization. When there are requirements established by governmental agencies to furnish such reports, specific reference to such regulatory authorities may be made.

The interpretation reminds the auditor that SAS No. 60 prohibits issuance of a written report stating that no reportable conditions were noted during the audit. In a report on the existence of material weaknesses, the auditor should not imply that no reportable conditions were noted.

Exhibit 14-5 illustrates a report on the existence of material weaknesses where no material weaknesses were noted. If material weaknesses have come to the auditor's attention during the audit, the report should describe those weaknesses. The last sentence of the first paragraph of the report should be modified as follows, and paragraphs describing the material weaknesses should follow the first paragraph:

> However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

Exhibit 14-5 ***Report on the Existence of Material Weaknesses***

In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the AICPA. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

When the report includes comments on specific aspects of the internal control structure or on additional matters, the identification of the specific aspects or additional matters should be sufficiently detailed to prevent misunderstanding. Reference to specific portions of documents such as contracts or regulations may be useful in some cases.

Some reports on material weaknesses may include comments on specific aspects of the internal control structure (for example, to comply with a regulatory agency requirement or to comply with certain provisions in contracts or regulations). In such cases, the language in paragraph 4 should be modified to—

- Identify clearly the specific aspects of the internal control structure or the additional matters covered by the report.
- Distinguish any additional matters from the internal control structure.
- Describe in reasonable detail the scope of the review and tests concerning the additional matters.
- Express conclusions in language comparable to the preceding illustration as appropriate.

Reference to the Management Report in the Audit Report

This is an interpretation of SAS No. 58, *Reports on Audited Financial Statements,* which requires that the auditor's standard report contain a statement that the financial statements are the responsibility of the Company's management. The interpretation deals with this issue: When an annual shareholder's report (or other client-prepared document that includes audited financial statements) contains a management report that states that the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

The audit report should *not* refer to the management report. The statement in the audit report about management's responsibilities should not be modified in any way, such as by reference to the management report. Such reference or modification may confuse users of the financial statements. If the standard audit report is modified with such a reference, users may erroneously believe that the auditor is providing assurances about representations by management in the management report.

Subsequent Discovery of Facts by a Resigned or Discharged Auditor

This is an interpretation of Professional Standards AU Section 561. When new information comes to an auditor's attention subsequent to the date of the audit report that might affect the previously issued audit report, the auditor has the responsibility to undertake to determine whether the information is reliable and to undertake to determine whether the facts existed at the date of the audit report.

Professional Standards AU Section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* states these requirements. The interpretation addresses the auditor's responsibilities when the auditor has resigned or been discharged prior to undertaking or completing his or her investigation, as opposed to being the continuing auditor.

The requirements remain the same even when the auditor has resigned or been discharged.

State or Local Governments—Part of Audit Performed by Other Independent Auditors

This is an interpretation of Professional Standards AU Section 543. The basic financial statements of a state or local government are the general purpose financial statements (GPFS). The GPFS present in columnar form the combined financial statements of each of the government's fund types and account groups.

The interpretation addresses the following situation:

The governmental entity has chosen to issue a comprehensive annual report (CAFR), which includes—

1. The basic financial statements.
2. Combining financial statements.
3. Individual fund and account group financial statements.

The government unit engages one auditor to report on the combining, individual fund, and account group financial statements (other than those of one individual fund), in addition to reporting on the GPFS. These financial statements are presented together in the CAFR. The government unit engages another auditor to audit one fund's financial statements, which are included in the combining financial statements of one fund type. The auditor of the GPFS has concluded that it is appropriate to serve as principal auditor of the GPFS.

In this situation, the principal auditor should *not* express an opinion on the financial statements of a fund audited by another auditor. Paragraph 18.31 of the guide, *Audits of State and Local Governmental Units,* states—

> If the auditor is engaged to examine the combining and individual fund and account group financial statements in addition to a GPFS . . . the auditor's opinion addresses each presentation as a primary statement.

The auditor's opinion separately addresses each fund's financial position, each account group's financial position, the results of each fund's operations, and the cash flows of each proprietary fund and similar trust fund, as presented in the combining, individual fund, and account group financial statements.

The auditor should make separate decisions about whether he or she may serve as principal auditor for each of these financial statements. Exhibit 14-6 illustrates a report that the principal auditor of the GPFS should issue in this situation.

Exhibit 14-6 ***Independent Auditor's Report***

We have audited the general-purpose financial statements of the City of Example, Any State, and the combining, individual fund, and account group financial statements, other than the financial statements of the Parks Fund, of the City as of and for the year ended June 30, 19XX, as listed an the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the financial statements of the Parks Fund, which statements reflect total assets of $________ as of June 30, 19XX, and total revenues of $________ for the year then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion on the general-purpose financial statements, insofar as it relates to the amounts included for the Parks Fund in the special revenue fund type, is based solely on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of the City of Example, Any State, at June 30, 19XX, and the results of its operations and the cash flows of its proprietary and similar trust fund types for the year then ended in conformity with generally accepted accounting principles. Also, in our opinion, the combining, individual fund, and account group financial statements of the City of Example, Any State, referred to above (other than the

Parks Fund, whose financial statements were audited by other auditors whose report expressed an unqualified opinion) present fairly, in all material respects, the financial position of each of the individual funds and account groups at June 30, 19XX, and the results of operations of such funds and the cash flows of individual proprietary and similar trust funds for the year then ended, in conformity with generally accepted accounting principles.

Oil- and Gas-Producing Activities—Required Supplementary Information

This is an interpretation of Professional Standards AU Section 558 on required supplementary information. The interpretation adds new provisions that the auditor should consider and clarifies that the auditor should consider the provisions of Professional Standards AU Section 558 for circumstances involving the following information:

1. SFAS 69 (AC section Oi5), *Disclosures about Oil- and Gas-Producing Activities*, requires publicly traded entities that have significant oil- and gas-producing activities to include, with complete sets of annual financial statements, disclosures of proved oil and gas reserve quantities, changes in reserve quantities, a standardized measure of discounted future net cash flows relating to reserve quantities, and changes in the standardized measure.
2. In documents filed with the SEC, Regulation S-K requires that the disclosures related to annual periods be presented for each annual period for which an income statement is required and the disclosures as of the end of the annual period be presented as of the date of each audited balance sheet required.

In addition to considering the provisions of Section 558, the auditor should consider the new provisions in the interpretation. The auditor's inquiries directed to management's understanding of the specific disclosure requirements should include such matters as—

- Factors considered in determining the reserve quantity information (e.g., reserves relating to royalty interests owned).

- Separate disclosure of a variety of items (e.g., reserves subject to long-term agreements with governments).
- Factors considered in determining the standardized measure of discounted future net cash flows.

In addition, the auditor should—

1. Inquire about the qualifications of the reserve estimator.
2. Compare recent production with reserve estimates and inquire about disproportionate ratios.
3. Compare the reserve quantity information with depletion and amortization information and inquire about differences.
4. Inquire about the calculation of the standardized measure. The interpretation lists seven matters that might be included in such inquiries.
5. Inquire about whether the estimation methods and bases are documented and whether the information is current.

If the auditor believes that the information may not be presented within the applicable guidelines, Section 558 indicates that additional inquiries should be made. Because of the nature of estimates of oil and gas reserves, the auditor may not be in a position to evaluate the responses to such additional inquiries. This is a limitation on the procedures prescribed by professional standards and should be reported. The interpretation provides an illustration of report language for such circumstances.

The details of the new provisions are not listed in this summary. The auditor should refer to the interpretation for the specific listings of factors and items to be addressed.

NOTICES TO PRACTITIONERS

Compliance Auditing

This notice to practitioners concerns reporting under SAS No. 63 when SAS No. 55 has not yet been adopted. The reports illustrated in SAS No. 63 contain a description of the scope of the auditor's consideration of the internal control structure based on SAS No. 55. If the auditor has not implemented SAS No. 55, this description should not be used. Instead, the description should be based on Professional Standards AU Section 320. The following illustrates such a description:

> Our consideration of the internal control structure included all of the control categories listed above except that we did not evaluate the internal control structure over [identify any category not evaluated] because [state reasons for excluding any category from the evaluation]. The purpose of our consideration of the internal control structure was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the entity's financial statements.

If the auditor has not made a study and evaluation of any significant category of the internal control structure beyond the preliminary review phase described in Professional Standards AU Section 320.53 through 320.55, a description such as the following should be used:

> Solely to assist us in planning and performing our audit, we made a study and evaluation of the internal control structure of [name of entity]. That study and evaluation was limited to a preliminary review of the structure to obtain an understanding of the control environment and the flow of transactions through the accounting system. Because [state reason], our study and evaluation did not extend beyond this preliminary review phase.

Reissued Reports and SAS No. 58

As issued, SAS No. 58 was to apply to reports issued or reissued on or after January 1, 1989. However, to avoid implementation problems for certain cases of reissued reports, the Auditing Standards Board has concluded that an auditor who reissues a report that was issued before January 1, 1989 has the option of using either the SAS No. 2 form of auditor's report or the new SAS No. 58 form.

Amendment Proposed to Going-Concern Report

This issue was discussed earlier in this chapter as part of the 1990 Omnibus Statement on Auditing Standards, Exhibit 14-3 illustrates the report language that should be used.

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