Theory and Practice: Current Studies and Concepts

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THEORY AND PRACTICE

Current Studies and Concepts

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This month the column will discuss several items, some of which were discussed in previous columns when they were in the exposure stage of drafting by the American Institute of Certified Public Accountants.

Accounting Changes

The exposure draft of this Opinion, which has now been issued as APB Opinion No. 20, was reviewed in the May issue. As issued, the Opinion differs from the exposure draft in one major and three minor respects.

The major difference is that the Opinion permits certain changes in accounting principles to be made retroactively in financial statements. These changes are limited to (1) a change from the LIFO method of inventory pricing to another method, (2) a change in the method of accounting for long-term construction type contracts, and (3) a change to or from the "full cost" method of accounting which is used in the extractive industries.

One minor difference is that the exposure draft provided that the explanation in the financial statements of the justification for the change should explain how the newly adopted accounting principle results in more useful financial statements for users of financial statements. The Opinion provides for this justification to be made in terms of the alternative accounting principle being preferable.

The second minor difference is that the exposure draft provided for disclosure of all pro forma effects of the change only on the face of the income statement. The Opinion permits disclosure of the per share pro forma effects in the notes or in a separate schedule when space does not permit their disclosure on the face of the income statement.

The third minor difference is that the Opinion added a specific requirement for disclosure of the effect of the change on the current year's income before extraordinary items, net income, and related per share amounts.

Piecemeal Opinions

The exposure draft of this Statement, which was discussed in the July 1971 issue, has now been issued as Statement on Auditing Procedure No. 46. The Statement has been issued in approximately the same form as it was exposed.

Interest on Receivables and Payables

The Accounting Principles Board has now issued its Opinion on this subject.

Effective date

The Opinion, which was adopted unanimously by the Board members, is effective for transactions entered into on or after October 1, 1971. The Board believes that the conclusions as to balance sheet presentation and disclosure should apply to transactions made prior as well as subsequent to the issuance of the Opinion. The Opinion is not intended to require the discounting of notes existing on September 30, 1971 which were not previously discounted, although notes that have previously been recorded in the fiscal year in which October 1, 1971 occurs may be adjusted to comply with the provisions of this Opinion. Notes that were previously recorded in fiscal years ending before October 1, 1971 should not be adjusted.

Applicability

The principles discussed in the Opinion are applicable to receivables and payables which represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest, except for the following:

(1) Receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year;

(2) Amounts which do not require repayment in the future, but rather will be applied to the purchase price of the property, goods, or service involved (e.g., deposits or progress payments on construction contracts, advance payments for acquisition of resources and raw materials, advances to encourage

exploration in the extractive industries);

(3) Amounts intended to provide security for one party to an agreement (e.g., security deposits, retainages on contracts);

(4) Customary cash lending activities and demand or savings deposit activities of financial institutions whose primary business is lending money;

(5) Transactions where interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (e.g., industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlements); and

(6) Transactions between parent and subsidiary companies and between subsidiaries of a common parent.

The Opinion is also not intended to apply to, and the Board is not presently taking a position as to, the application of the present value measurement (valuation) technique to estimates of contractual or other obligations assumed in connection with sales of property, goods, or service, for example, a warranty for product performance.

Provisions

The Opinion states when a note is received or issued solely for cash and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged. It also states that if cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges should be given accounting recognition by establishing a note discount or premium account which should be amortized over the life of the note preferably using the "interest" method. This method results in a constant rate of interest being applied to the amount outstanding at the beginning of any period.

The Opinion provides that other methods may be used provided the results obtained do not differ materially from those that would result from the "interest" method.

The Opinion also states that when a note is exchanged for property, goods, or service in a bargained transaction entered into at arm's length, there should be a general presumption that the rate of interest stipulated by the parties to the transaction represents fair and adequate compensation to the supplier for the use of the related funds. It states, however, that presumption must not permit the form of the transaction to prevail over its economic substance and thus would not apply if (1) interest is not stated, or (2) the stated interest rate is unreasonable, or (3) the stated face amount of the note is materially different from the current cash sales price for the same or similar items or from the market value of the note at the date of the transaction. Under the latter circumstances, it provides that discount or premium should also be recognized and accounted for as described above.

The Opinion provides that in the absence of established exchange prices for the related property, goods, or service or evidence of the market value of the note, the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable should be determined by discounting all future payments on the notes using an imputed rate of interest. It states that this determination should be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates should be ignored.

The Opinion contains general guidelines for determining the imputed rate of interest. It states that the objective is to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase which bears the prevailing rate of interest to maturity.

The Opinion provides that the discount or premium resulting from the imputation of interest should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It states that it should not be classified as a deferred charge or deferred credit. It requires the description of the note to include the effective interest rate and the face amount and the amortization of discount or premium to be reported as interest in the statement of income. It states that issue costs should be reported in the balance sheet as deferred charges. This statement presentation is applicable in all circumstances.

Subsequent Events

The Committee on Auditing Procedure has now issued its Statement on this subject. The purpose of the Statement is to provide guidelines as to which events occurring subsequent to the date of financial statements but prior to issuance of the auditor's report require adjustment of the financial statements and which require disclosure.

Those which require adjustment of the financial statements consist of events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. The Statement states that all information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based.

It states that identifying events that require adjustment of the financial statements calls for the exercise of judgment and knowledge of the facts and circumstances and gives as an example a loss on receivables. It states that a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance sheet date would be indicative of conditions existing at the balance sheet date, thereby calling for adjustment of the financial statements before their issuance. A similar loss resulting from a customer's major casualty such as a fire or flood subsequent to the balance sheet date would not be indicative of conditions existing at the balance sheet date and adjustment of the financial statements would not be appropriate.

Those which require disclosure consist of events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date, disclosure of which is required to keep the financial statements from being misleading. Examples of such events are:

1. Sale of a bond or capital stock issue.
2. Purchase of a business.
3. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance sheet date.
4. Loss of plant or inventories as a result of fire or flood.
5. Losses on receivables resulting from conditions (such as a customer's major casualty) arising subsequent to the balance sheet date.

The Statement also discusses auditing procedures to be employed in the period subsequent to the date of the financial statements, dating of the independent auditor's report, events occurring after completion of field work but before issuance of the auditor's report, reissuance of the auditor's report, and the auditor's report in a filing under the Securities Act of 1933.

SEC Matters

Certain SEC proposals for amending Forms 8K and N-1Q were discussed in the September issue. These proposals were disposed of as follows:

1. The proposal requiring disclosure in the Forms of material charges and credits of an unusual nature was adopted for Form 8K but not Form N-1Q. The latter proposal was dropped because investment companies ordinarily do not have significant amount of such transactions.
2. The proposal requiring the registrant to report a change in independent accountant was adopted for both Forms with some procedural modifications.
3. The proposal to require reporting of accounting changes in Form 8K has been changed to require their reporting in Forms 7Q, 10Q, and 10K. This proposal was adopted for Form N-1Q.

FROM OUR PAST

"In a talk given at the October meeting of the New York State Society of CPAs, Dr. William J. Wallen, Chancellor of the Board of Regents of the State of New York, made a statement that 'the most angelic profession by far is the CPA profession'."

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We wonder if today's educators feel the same!