The Woman CPA

JANUARY, 1977 VOLUME 39, NUMBER 1

JANUS:

**Deity of Doorways
Through Which The Past
Moves to the Future**

Luca Pacioli:
accountant for medieval Venice

Grants and Contracts:
intimation of future accounting

CPE
path to professional survival

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Editor's Notes

Janus, the old Roman God of Doorways, had unique anatomical ability for looking in both directions at one time. Forward and backward vision is the stuff of legends but it is entirely appropriate to doorways that stand along the way from points of origin to places of destination.

The temple of Janus was dedicated to beginnings, first events, first months, and so our year begins with January. It says something of the sophistication of archaic society when one considers its association of beginnings with that simultaneous gaze into the past and toward the future. To those antique Romans the beginning was part of a continuum. And so it is. The marvelous complication that we call the human body has evolved from some mysterious single cell in pre-history; knowledge, too, has accumulated bit by bit along with an evolving mentality to contain it. It would be fatuous to identify one single event as the beginning of civilization, or the beginning of accounting, or the beginning of this first issue of Volume Thirty-Nine of The Woman CPA.

There are some apparent beginnings along the way, nevertheless. In the pages that follow we present the story of Luca Pacioli who is acknowledged by the accounting profession to be its first compiler. The double-entry bookkeeping system was not his invention (although as a skilled mathematician he had more than sufficient ability for the task) but he had the prescience to record and classify double-entry accounting techniques that were in popular usage way back in fifteenth century Venice. He identified journals and the ledger, segregated expenses and revenues as distinct from capital items, and prescribed some astute internal control practices as defense against theft by wily members of large medieval households.

Pacioli had a certain ambivalence in his outlook. He was, in effect, a man who wore two hats because he was educated as a Franciscan monk and brought a priestly purity of view to business transactions, yet when the proscription of the Church was too demanding he could mentally exchange his monk's hood for the cap of a worldly-wise young merchant. Rigorous truth was his preference, yet in accomodation to reality he could at times distort the truth in his ledgers to avoid ecclesiastical censure. He lived at a time when commerce was dominated by the Church of Rome; were he to reappear as an accountant today he might feel quite at home in a world of business that is dominated by government agencies.

Government is recognized within our pages by a somewhat rueful look at the accounting red tape that winds around grants and contracts at an educational institution. Educational support is only one part of an enormous subsidy system throughout the land, of course, yet the plight of the academies is closely similar to that of hospitals and research centers and a host of other public services. The gift of government monies is essential; will take-over by the government ineluctably follow? One can imagine old Janus with his 180-degree visual talents looking backward to an even older time to something called the Trojan horse.

Our first issue of the new year also explores Continuing Professional Education requirements for both the public practitioner and the academician because accountants acknowledge CPE to be a part of their travel equipment on the road to professional survival.

Survival. One of the aphorisms of the educated is that the more one knows, the less obvious is the answer. A knowledge of history and insight into many different points of view may be vitiating as well as enlightening. The lassitude of old age is partly failing strength but is in larger part a sense of de ja vu and having seen too much, and conversely the dynamism of youth is as much due to single-mindedness as to physical vitality. Yet the view through the doorway into the new year is disquieting for accountants regardless of the perspective.

Early last November the accounting profession was threatened by the federal government's weaponry in a section of a report by a House subcommittee on federal regulatory reform, headed by Representative John E. Moss. The report was a diatribe on the ineffectiveness of the Financial Accounting Standards Board and it proposed that the Securities and Exchange Commission be required to "prescribe by rule a framework of uniform accounting principles." The Moss hearing was so lacking in impartiality as to be opinionated. In fact, it heard the testimony of only one witness, Professor Abraham Briloff of the City University of New York, whose frequent criticisms of the accounting profession are designed to be readable, amusing, salable, and only coincidentally fair.

If the recommendations of the Moss report are effected they will empower the Securities and Exchange Commission to gradually commingle the standard setting process for accounting with the commission's traditional obligation to detect fraud. The harsh persuasion of the SEC that has already burdened accountants will become absolute regulation, and thus will begin an end to professional independence.

When Numa Pompillius, the second King of Rome and successor to the wolf-suckled Romulus, erected his temple to Janus he directed that the gates be closed only in times of peace. During his pacific thirty-nine year reign they were indeed closed but for most of Rome's violent history the Janus gates were left open to launch the attack. Accounting, in its continuously besieged condition, may find some affinity with the cult of the mythical Janus and make supplication that its professional prospect be at least as good as the retrospect.

Luca Pacioli and the Summa

Lorena C. Lommler

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First-time readers are apt to bring amused tolerance to a small treatise on bookkeeping written in 1494 by a Franciscan monk, Fra Luca Pacioli.[1] His book, titled *Summa de arithmetica, geometria, proportione et proportionalita* (Everything concerning arithmetic, geometry and proportion), contains thirty-six chapters which describe a system of bookkeeping by double entry which was in use in the Italian city of Venice.

With a feeling of condescension one begins what is, presumably, an elementary attempt by simple ancients to deal with the beginnings of a complex and demanding modern profession. Such presumption! Pacioli's outline of the proper use of the journal and general ledger could be used, with only minor alterations, by a bookkeeper working today. The writer was obviously not a "simple ancient." He was, in fact, one of the great mathematicians of his time.

The object of this paper is to acquaint the reader with Pacioli, and then review that section of the *Summa* entitled, "Of Reckonings and Writings" (*De computis et scripturis*), in which the double-entry method of bookkeeping was set forth in detail for the first time.

Luca Pacioli was born around the year 1445 in Borgo San Sepolcro, a little town in central Italy. His family was one of modest means, and so young Pacioli was apprenticed to a merchant in the town. His religious training was acquired from Franciscan friars. In his early twenties, he became a tutor to the sons of the wealthy Rompiasi family of Venice. Later, he taught at the universities of Italy becoming the first professor to fill a chair in mathematics.

During his lifetime, Pacioli became learned in a diversity of subjects encompassing such areas as philosophy, theology, sculpture, painting, mathematics, and architecture — he was truly a "Renaissance Man." His life was one of fortunate circumstances: the guidance of Piero della Francesca, the famous painter who also was born in San Sepolcro; the friendship of fellow-student, Giuliano della Rovere, who later became Pope Julius II; access to the excellent library of the Duke of Urbino; the companionship of Leon Battista Alberti, well-known artist and author with whom Pacioli lived for a while in Rome; a close friendship with the great Leonardo da Vinci; and the backing of a strong religious order, the Order of Franciscans Minor, which he joined in the 1470's. He became one of the most celebrated scholars of his day, a friend of seven successive popes, and associate of many great and powerful men.

Pacioli wrote his *Summa* for the purpose of summarizing existing knowledge of mathematics. The section on bookkeeping was added almost as an afterthought. He explains its inclusion this way: "In order that the honorable subjects of the most gracious Duke of Urbino may have complete instructions in the ordering of business, I have decided to go beyond the scope of this work and add this most necessary treatise."[2] Pacioli makes clear that the system being described was not originated by him, but that "...the system employed in Venice will be adopted here, for it is certainly recommended above all others." While Pacioli did not invent double-entry bookkeeping, he was the first to bring the elements together into a coordinated system and present it in a printed work. It is for this he has earned the title, "The Father of Accounting."

...not a "simple ancient," but one of the great mathematicians of his time.

How did Pacioli acquire such an amazing grasp of detail as is evidenced in his treatise? He was never a bookkeeper, and this has given rise to doubt that "he could have written on the subject with such clearness and wealth of detail without the help of some unknown author."[3] However, it is quite likely that during his early apprenticeship, he observed the bookkeeping process or even assisted in it. He may also have thought it necessary to thoroughly investigate the subject during the period he served as tutor in the Rompiasi household in order to better instruct his young charges who would someday be expected to assist with their father's business affairs.

Pacioli begins his treatise by setting forth the "... three things necessary to one who wishes to operate a business successfully." He states: "The most important is cash, or some equivalent economic power. The second... is to be a good accountant and a ready mathematician. The third... is that all the businessman's affairs be arranged in a systematic way so that he may get their particulars at a glance." The reader should keep in mind that Pacioli's work was not intended as a textbook; he was addressing his instructions to experts — the local merchants. His writings are interspersed with religious admonitions reflecting his Franciscan training: "But above all keep God before your eyes, never forgetting to attend to religious meditation every morning, as the holy verse says."; and are sprinkled with such advice as: "If each thing is not in its right place, great trouble and confusion will arise. As the saying goes, 'Where there is no order, there is chaos.'"

The businessman's first task is to prepare an Inventory. "Carefully record all personal property and real estate, item by item (even if there were ten thousand), entering their condition and nature, and whether deposited or loaned. Every item must be systematically recorded in the Inventory with all countermarks, full names, and in as much detail as possible. Because of the vast number of things that might occur, transactions can never be too clear to a businessman."

The entire inventory is to be completed on the same day...

Pacioli presents an example of an Inventory, parts of which are given next so that the reader can appreciate the author's style and attention to detail. Notice that the day, year, and place are recorded first. The entire inventory is to be completed on the same day, otherwise "there will be future difficulty in managing the business."

An Example of an Inventory with All Its Formalities

In the Name of God
November 8, 1493
Venice

The following is the Inventory of myself of Venice, Street of the Holy Apostles.

I have written down systematically, or have had written by Mr. Bookkeeper, all my personal and real property, as well as that which is owed me and that which I owe on this day.

First Item

I have cash composed of both gold and coin of so many ducats, of which so many are gold Venetians, so many gold Hungarians, and so many Papal, Siennese and Florentine large florins. The remainder consists of various kinds of silver and copper coins, that is troni, marcelli, and carlini of the Pope and of the royalty, Florentine grossi, and Milanese testoni.

...sapphires set for women, and unset rubies, and uncut diamonds...

Second Item

I have so many pieces of set and unset jewels among which are many rubies set in flat-surfaced settings and gold rings weighing so many ounces, carats, or grains per piece or in total, (you may express this in your own way). There are so many sapphires set for women, and so many unset rubies weighing so much. The remainder consists of uncut diamonds weighing in total so many points. Here you may describe the type and weight as you desire.

Third Item

I have clothes of so many kinds. You may describe their condition, colors, linings, and styles.

Seventh Item

I have goods of various kinds at home or in warehouses. There are so many marked cases of mechini ginger weighing so many pounds. Describe each kind of such goods in detail by their marks. Give in the most accurate manner their weights, numbers, and measurements.

Tenth Item

I have very fine Armenti seal skins and various sable skins of so many of each kind.

Carefully and truthfully describe each item in its turn. Let truth always be your guide. Carefully distinguish the items by numbers, weight, or measurement, beacuse it is customary everywhere to conduct business in these three ways. Certain things are classed by thousands, others by hundreds, others by pounds, others by ounces, others by number, others by unit (as with leather goods of skins), others by piece (as with jewels and fine pearls). Record each of them individually. These examples will guide you in determining other cases.

Eleventh Item

I have real estate of a house of so many stories, so many rooms, a courtyard, wells, gardens, and located on the street of the Holy Apostles over the canal, adjoining various specified places. Record the names of the adjoining properties, referring to the oldest and most reliable deeds available. If you have houses in other localities, enter them in a similar way.

Thirteenth Item

I have so many ducats on deposit with the Camera de l'Impresti and other Venetian banks, so many in the district of Canareggio, or part in one district and part in another. Give the names under which the ducats have been deposited, mentioning the book of the bank and the page number where your amount is stated. Give the name of the clerk who keeps the book so that you will be able to withdraw your money readily when you wish, because in such banks many accounts must be kept to serve the multitude that go to them. Carefully note the dates of their correspondence, so that you know the amount due you and what percentage they are answerable for.

Let truth always be your guide.

Fourteenth Item

I have so many debtors. One is Mr. Buyer, who owes me so many ducats. Name the debtors by their full names, where they live, how much they owe, and why. Mention whether there are written papers or notarial instruments between you. Indicate that you have so many ducats of good money to collect, which is the money due from reliable people. Otherwise, call their money bad.

Fifteenth Item

I have debts amounting to so many ducats. I owe so many to Mr. Seller. Give the names of your creditors in this way one by one. State whether everything is clear between you and if there are any written papers or instruments. Mention the persons present when the debt was incurred, how it was incurred, and the time and place; all these particulars may be necessary for any case in or out of court.

Notice that Pacioli arranges his assets in much the same order as they are listed on a modern balance sheet with cash and near-cash items listed first and then others of a more fixed nature. Notice also the labeling of bad debts in the Fourteenth Item.

Bookkeeping and The Summa

Memorandum, Journal, and Ledger

The merchant is advised to keep three books: the Memorandum the Journal, and the Ledger. The Memorandum is the book of original entry. Anyone who executes a transaction, whether an employee or member of the household, must enter in chronological order a complete explanation including the particular monetary unit used. No particular attention need be paid to form in the memorandum. Since there was no uniform monetary system in the Middle Ages, the bookkeeper's first task was to convert each item in the Memorandum to the monetary unit in which his accounts were kept. The Inventory, together with these entries, were then transferred to the Journal and there put in proper form for posting to the Ledger.

Beginning with the Journal, form became all-important. The debit is stated first, the credit next, with the explanation following — all in one continuous paragraph. There is only one column of money values. Pacioli carefully explains two terms: "Cash means the money on hand. Capital means the entire amount of what you now possess." And then goes on to give several examples of how the Inventory should be entered. Pacioli's first entry follows:

8th day of November,
MCCCCLXXXXIII, in Venice

First Debit Cash, credit Capital of myself, Mr. Business man. At present I have cash in a certain place, consisting of gold, coin,
1 silver, and copper of various coinage as shown on the first sheet of the Inventory, in total so many gold ducats and so
2 many ducats in coin. In our Venetian money all is valued in gold, that is 24 grossi for each ducat and 32 picioli for each grosso, and so many gold lire.

Value: lira, soldi, grossi, picioli

The two numbers at the left indicate the page number of the debit and credit entry in the Ledger.

Pacioli now explains the use of the Ledger. He recommends that it contain an Index in which all debtors and creditors are listed in alphabetical order, together with the numbers of their respective pages. No explanation could be clearer than Pacioli's own: "Having numbered the pages of the Ledger and placed the date at the top right and left margin, enter Cash as a debit on the first page, as it is in the Journal. Reserve the entire first page for Cash; do not enter anything else as a debit or credit because cash entries are more numerous than all others. This is because money is almost continuously being received or withdrawn, therefore, it needs much space.

"Each of the entries made in the Journal must be posted twice in the Ledger, one to the debit and the other to the credit. In the debit posting, indicate the page number where the respective credit entry is to be found. All the items in the Ledger are cross referenced in this way, and you must never post a transaction to the debit without posting the related credit, nor must you ever make a credit entry without its respective amount being ready to be entered as a debit. The balancing of the Ledger depends on this. The books cannot be closed unless the debits equal the credits."

Ventures, Not Fiscal Periods

The modern practice of balancing at periodic intervals was not the custom during Pacioli's day; instead, each transaction was treated as a separate venture. As each venture was completed, its account balance was transferred to the Profit and Loss account. Uncompleted ventures were simply shown as a balance on the list of assets. This method of dealing with profit was the most convenient that could have been adopted for conditions of the times, and explains why bookkeepers did not keep a general goods account nor feel that it was necessary to balance at regular periods. Pacioli explains that a credit balance in the Profit and Loss account represents a profit, and a debit balance represents a loss "from which latter may God preserve every man who proves himself a true Christian."

The merchant is then instructed: "The Profit and Loss account will then be closed and transferred into the Capital account, which is always the last in all Ledgers. It is consequently the receptacle of all other accounts."

Trial Balance

Pacioli next explains the preparation of the Trial Balance. "So that everything regarding the closing will be clear, summarize all the debit totals that appear in the Ledger at the left of a sheet of paper, and all the credit totals at the right. Then sum all of the debit items (which is called the grand total), and likewise total all of the credit items (which is also called the grand total). The first is the grand total of the debits and the second the grand total of the credits. Now if the two grand totals are equal, you may conclude that the ledger was well kept and closed, ... However, if one grand total exceeds the other, it would indicate an error in the Ledger. This error must be searched out diligently..."

a credit balance in the Profit and Loss account represents a profit, and a debit balance a loss "from which latter may God preserve every man......"

After balancing the Ledger, and before a new book is commenced, a careful comparison of the Journal and Ledger is to be made. Here is Pacioli's description of the process. "First, try to get a helper for it is difficult to do alone. Give the Journal to him for greater precaution, while keeping the Ledger for yourself. Then, beginning with the first entry in the Journal, tell him to call out the numbers of the Ledger pages where the entry should have been posted, first the debit, then the credit. Always find the page in the Ledger that he calls and check to see that the entry (the kind, for what, whom, and the amount) he calls is the same. If it is the same, say so. Finding that it is the same in the Ledger as in the Journal, mark it off by checking or dotting it or placing any proper mark over the lire mark, or elsewhere, so that it can readily be seen. Ask your helper to make this mark (the one you use depends largely on the custom of your locality) in the Journal at the same entry. Take care that neither of you marks an entry without the other doing so, as great errors might then arise. Once an entry is marked it is assumed to be correct.

"Having proceeded in this manner through all the accounts in the Ledger and Journal, and having found that the debit and credit entries correspond, it will mean that the entries are properly placed and correct.

"Take care that your helper shall mark each entry in the Journal with two checks, dots, or other marks, while in the Ledger, you will make only one for each entry. This is because for every entry in the Journal there are two made in the Ledger.

"After finishing the checking of the Journal you find some account or entry which has not been checked off in the debit or credit in the Ledger, a mistake in the Ledger has been made. A superfluous debit or credit entry has been posted, and you should correct this error at once by posting a similar amount on the opposite side. If the superfluous entry was on the debit side, you would make similar entry on the credit side and vice versa, thus making everything correct.

"Should your helper find some entry in the Journal which is not found in the Ledger, an error in the Ledger has occurred. A correction should again be made, but in a different way. Immediately debit and credit the unposted entry to the Ledger, explaining the difference in the dates, for the entry would be made at a date much later than it should have been. A good bookkeeper should always mention these differences and why they are, so that the books are above suspicion.

"Sometimes entries are found in the Ledger which have not been checked to related entries in the Journal, because they cannot be found in the Journal. These represent the balances posted to the debit or to the credit to close accounts carried forward. The correlative entries in the Ledger relating to these balances will be found on the page numbers indicated in these accounts. Finding the related entries in their proper places, you may conclude that your Ledger is in proper order."

In addition to those reviewed in this paper, Pacioli gives instructions covering such other subjects as Expense and Petty Cash account, Partnership and Agency accounts, and the proper precautions to take in dealing with public officials and with banks. He recommends that all documents be properly identified and filed, and even advises the businessman to keep a reminder book in which should be entered all things that he might forget, going over it each night before retiring, crossing off what has been done, and reviewing what is yet to be done.

Medieval Omissions

Enthusiasm for Pacioli may mislead the reader into thinking all accounting problems were anticipated by him at that early date, so consider some that were not dealt with in his treatise.

First, it was not the custom to compute profits annually. As a rule, books were closed and income determined on three occassions: (1) when the Journal and Ledger were full, (2) when a venture was completed, or (3) when the merchant died. There were several reasons for this lack of concern with the computation of annual profit. One was that more importance was placed on the ability of double entry to provide an orderly record of transactions rather than on its ability to report on the progress of the enterprise. This appears reasonable when it is remembered that the average business of the time was small and the owner-manager often was familiar enough with his business to forego the annual determination of income. It is also compatible with the venture-type transaction which was usually undertaken as a partnership and terminated at the completion of the venture. Many current procedures dealing with accruals, deferrals, and the distribution of burden are the result of the necessity to assign income to a particular time period.

Secondly, there were no provisions for financial statements. Form was more emphasized than summarized statements for control. The reason for such omission was the same as that given for the lack of annual income determination; viz., the personal contact of the owner with his business.

Third, depreciation was not considered as a cost since the businessman did not attempt to assign the cost of his fixed assets to units of production, or to a series of productive periods.

Pacioli did not spend time theorizing; he was a practical man...

And finally, Pacioli did not spend time theorizing; he was a practical man intent on making available to his fellowmen the clearest possible instructions to guide them in the handling of their daily business affairs. To ensure the widest possible usage he had his treatise printed in Italian, the common language of the people, contrary to the custom of scholars of his day who published in Latin.

Enduring Concepts

On the other hand, many of the fundamental characteristics of the double-entry bookkeeping of Pacioli's day have remained basically unchanged.[4] For example, the bi-lateral form which requires the grouping of like elements on one side, and related, but opposite, elements on the other so that subtraction by opposition is indicated resulting in a balance for the account.

The Trial Balance is still prepared from the Ledger by listing debit balances in one column, and credit in another. If the two columns have equal sums, the Ledger is in balance.

The sequence of bookkeeping operations remains the same: the entry of inventory; an original record of transactions; entry of transactions in the Journal arranged by debit and credit; posting into Ledgers; testing for balance; closing of the nominal accounts to Profit and Loss; and finally closing Profit and Loss to the Capital account.

It was inevitable that such a clear and practical guide as Pacioli's *De computis et scripturis* would become the standard. His treatise was translated into many languages and was widely used throughout Europe and the British Isles.

A reading of Pacioli's work is recommended to all newcomers to the field of accounting as a means of gaining proper historical perspective. It is also worthwhile for those already in the field.

Today's public accountant often feels besieged and in danger of losing his equanimity. He is constantly harassed by taxing authorities, bankers, investment analysts, businessmen and politicians — all fighting for concepts that best serve their potentials for economic gain. Accounting concepts are, and probably always will be, under continuous attack and revision. In such an atmosphere, accountants can gain assurance from, and be justifiably proud of, their "ancestor" who advocated "...respect for the good bookkeeper."

Footnotes to Luca Pacioli

[1] Some controversy exists as to the correct spelling of Pacioli's name. Some writers maintain that the correct form is "Paciolo" rather than "Pacioli". For a discussion of the subject, several articles published in *The Accounting Review* are suggested: "The Name of Paciolo" by Alfred V. Boursy, July 1943, pp. 205-209; "Paciolo or Pacioli?" by Raymond de Roover, January 1944, pp. 68-69; "The Name of Pacioli" by R. Emmett Taylor, January 1944, pp. 69-76.

[2] *Summa* excerpts are from a translation in contemporary English: R. Gene Brown and Kenneth S. Johnston, *Paciolo on Accounting* (New York: McGraw-Hill Book Company, Inc., 1963).

[3] Edward Peragallo, *Origin and Evolution of Double Entry Bookkeeping* (New York: American Institute Publishing Co., 1938), p. 56.

[4] A. C. Littleton, *Accounting Evolution to 1900* (New York: Russell and Russell, 1966), p. 81.

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Editorial note:

Pacioli would have been astonished to have his story appear in a journal dedicated to women in the accounting profession because in his time education, of sorts, was a privilege limited to women of noble birth. A matter-of-fact revelation about the general illiteracy of women occurs in his discussion of the Memorandum Book when he admonishes the businessman to make sure that daily activities are recorded, even in his absence. Pacioli points out that the servants of the household can make the daily entries in the Memorandum, or they can also be made by the master's women if they know how to write.

Grant and Contract Accounting in an Educational Institution

Wilma Loichinger

Wilma Loichinger has been Assistant Controller for Grants and Contracts at the University of Cincinnati, and most recently the Chief of Grants and Contracts for the University of Alaska at Fairbanks. She holds a B.S. degree in Business Administration from the University of Cincinnati and was the charter president of the Cincinnati Chapter of ASWA, where she still retains her membership.

"Not for Profit" Accounting is a unique branch of the accounting profession. It is used in hospitals, non-profit institutions, universities, municipalities, states and in the biggest business of all, the federal government. Within these larger divisions of the field there are smaller divisions that have their own special accounting requirements that must be provided for when an accounting system is created. One of these is the accounting for grants and contracts in an educational institution.

Universities can no longer survive with their income limited primarily to the tuition receipts from the students attending their programs. Inflation has increased costs in all institutions to the point where few students can afford the total cost of the courses offered. In addition, to offer graduate degrees a university must provide elaborate laboratory facilities and expensive equipment as well as highly trained personnel to conduct those programs. The only recourse is to outside funding to help support the programs.

Most universities are requesting and receiving aid from their state governments, who in turn receive part of this support from the federal government. The universities are also making direct requests to the various federal, state, municipal and private agencies for funding of training and research programs. It is at this point that the most stringent restrictions are met. Each federal agency has its own set of rules and regulations in spite of the attempts by the federal government for many years to standardize requirements. Regulations are either listed in the award document or in a manual issued by the agency which details accounting and reporting requirements as well as other controls of the project operation.

If a university receives any sizeable support of this type from a number of agencies it would be wise to create a grant and contract accounting department. Such a department can concentrate on the various federal and non-federal requirements for control, billing and reporting of these funds in the peculiar methods mandated by those agencies.

Grant and Contract Accounting Budget Requirements

One of the biggest problems created by the incorporation of grant and contract accounts in the general accounting records of the university is the mismatch of the grant or contact period to the university fiscal year.

Provision must be made in the accounting system to provide the project director of a sponsored program with a complete picture of the financial position of his project, including the total budget and total expenditures to date, even if the project crosses several university fiscal years. There should be a special program for this section of accounts that will insert only the current fiscal year operations in the general accounting system yet will permit the fiscal report for the project to contain data from past years as to budget and expenditures, and the future years' budgets that apply to this project, as well as the current year's budget and expenditure data.

More and more universities are recognizing the fact that many agencies do not cover the full costs of the programs they propose to support. Therefore they are requiring an estimate of restricted funds as well as general funds in the annual budget preparation, with prior approval required if a division of the university exceeds its restricted fund estimate, before acceptance of the award document. They realize that most programs require some support by other university funds and control must be maintained on the acceptance of those restricted fund programs to prevent a drain of other university funding beyond the provisions in the budget. Such allowable restricted funds budget estimates are reduced by the unused balances of the project budgets carried forward from the previous fiscal year.

Some awards specifically identify the amount of cost of the project to be supported by the university funds thru the listing of "cost sharing" identified in the budget. Both parts of the budget become the total project budget and the agency will pay only a fixed percentage of the total cost. The amount of cost sharing required by federal agencies has increased dramatically over the last few years. In some cases it has risen from a 1 percent to 2 percent sharing to 10 percent to 15 percent sharing. Some programs require institutions to support as much as one third of the cost of the project. As federal funds are reduced or remain stationary and requests for support from institutions increase, the agencies are trying to spread the available funds further by requiring more and more sharing of the program costs by institutions.

Cost sharing is also involved when the project does not include the full overhead rate established for that division of the university. The total cost of conducting a project is the direct costs plus the proper overhead costs, but many universities have failed to recognize the drain on their funds by the reduction or complete removal of the overhead costs on many projects. Costs are incurred by each project and if the project funds do not cover them, other funds of the university must. Care should be taken in the acceptance of such projects and full recognition should be given to the use of other university funds to support each project.

A university may elect to accept a project with less than proper overhead charging because:

(1) The program contributes to the instructional or research goals of the university.

(2) The program is a pilot project that will lead to a sizeable program bearing proper overhead charges.

(3) The program is a community or state public service project in which the university should participate.

In any event, recognition of full cost to the university of overhead expenses not charged to the project should always be made.

Grant and Contract Accounting for Overhead Costs

When federally sponsored programs are accepted by a university, that university is required to establish overhead rates to be charged to these programs. Allowable costs to be included in the rates, as well as suggested methods of allocation of those costs, are listed in Federal Management Circular FMC 73-8 "Cost Principles for Educational Institutions" issued by the General Services Administration, Office of Federal Management Policy. The overhead costs in these rates include:

(1) the proportionate part of administrative costs, both general and departmental, that apply to the projects,

(2) operation and maintenance costs for space occupied,

(3) a use charge allowance for building and equipment used, or depreciation charge for same. (This is allowed only on assets purchased with other than federal funds.),

(4) use of library by personnel on the projects,

(5) student service costs for students employed on the projects, and

(6) staff benefit costs for personnel, or if staff benefits are direct charged by use of an estimated percentage, the under or over distribution of those costs.

Rates must be computed based on the total current general and current restricted expenditures for a fiscal year of the university. Proposed rates are submitted to the appropriate federal audit agency for audit and approval. Upon agreement of the university officials and the audit agency, the rates are submitted to the assigned federal negotiation agency and a negotiation agreement is prepared and signed by both parties. If the university and the audit agency do not agree on the rates established by the audit agency a formal negotiation session is conducted to establish mutually agreeable rates.

Universities can no longer survive with their income limited primarily to tuition receipts...

As mentioned, federal agencies are not bound to permit the charging of the rates thus established but may specify a lesser rate, or reject any allowance for overhead charge. The university must decide if it wishes to accept the funds under those conditions.

Recording of the cost of the overhead charge to the grant or contract accounts is another function peculiar to grant and contract accounting. The charge must show on the fiscal report of the grant or contact as part of the cost budgeted for that project. However, if the charge enters into the records of the university as an expense, the university is double charging for that expense: once as an overhead charge and again as an expense in administration costs, operation and maintenance costs or library costs. Therefore, the overhead charge is treated as a reduction of restricted funds in the general accounting records of the university and shown on the restricted funds schedule as such in a separate column on the annual financial report. However, on the monthly fiscal report for the grant or contract, it is shown as an expenditure from the overhead budget.

Accounting for Personnel Costs

The Federal Management Circular FMC 73-8 not only lists the requirements for preparation of overhead rates for the university but also lists the allowable and unallowable direct charges to projects and the certifications required to support such charges. The certification required to support the personnel charges to projects is the most stringent and has caused more disallowances by Federal Auditors than any other charge area.

FMC 73-8 specifies:

"The direct cost charged to organized research for the personal services of professorial and professional staff... will be based on instiutional payroll systems. Such institutional payroll systems must be supported by either (1) an adequate appointment and workload distribution system accompanied by monthly review performed by responsible officials... or, (2) a monthly after-the-fact certification system... Direct charges for salaries and wages of nonprofessionals will be supported by time and attendance and payroll distribution records."

The detail required for support of such charges is seldom a part of the general accounting system of the university unless all personnel are required to submit time sheets identifying accounts to be charged for hours worked. The academic climate of universities has traditionally caused professional personnel to shy away from specific time keeping, so an educational process is necessary to convince affected personnel that such records are necessary if federal funds are accepted for support of their project. Various methods of accounting are used in the universities including time cards, after-the-fact monthly listings of personnel payments to be signed by project directors or their representatives, and quarterly or even annual estimates of distribution of time or effort.

Each method has been more or less successful in its acceptance by the particular federal auditor according to the district in which the university is located. It is reasonable to anticipate that federal requirements may become more specific as to required format when federal funds become less available in relation to requests by universities, and therefore universities will agree to comply in order to obtain the funds.

Since the larger percentage of costs of most projects is composed of salaries and wages, which also generate staff benefit costs as well as overhead costs (if the rate is based on salaries and wages), it can be seen that the awarding agency would be most interested in being sure it is paying for such cost only on the basis of services received.

Grant and Contract Accounting for Equipment Purchases

Federal agencies vary in their allowance of charges for purchases of equipment from project funds, as well as the accounting for same. Equipment is identified as an item costing $200 or more and having an expected life of one year or longer.

Research equipment to be used on the project is usually an allowable charge but the university must be sure a similar piece is not already available for use and must obtain approval for expenditure for the item from the awarding agency. Items of general purpose equipment, identified as data processing equipment and office equipment, are allowed as a direct charge to a project only in special cases and must be specifically identified as to need. Such items are considered to be furnished by the university, but the project receives a use charge for them in the overhead rate.

Items of equipment costing over $2,-500 must go through the bid process, with three suppliers given the opportunity to bid unless the project director can justify the use of a sole source supplier.

Title to equipment as to the university or to the government varies by agencies. Contractors usually specify that title vests in the government with provision that items under $1,000 will transfer to the university with or without request. Title to items over $1,-000 can sometimes be obtained by request after a project is completed. Most grantees permit transfer of title to the university at point of purchase.

All government owned equipment must be properly tagged for identification and all government purchased equipment should be so identified in the university records. Segregated information is required when the value of equipment on hand is summarized for use in developing the overhead rates. A use charge or depreciation charge for such equipment is allowed only on equipment purchased with non-federal funds.

Agency rules vary as to the requirement of records concerning the inventory of government owned property and related maintenance expense. All contracts require at least a final listing of equipment purchased when a project is completed.

There are special rulings for charging travel to projects and prior approvals are required for foreign travel. There are entire sections of federal regulations regarding subcontracting part of a project.

The requirements for format of billing and reporting are as varied as the agencies supplying the funds, with special releases, assignments and certifications required to accompany the final billing. Methods of payment for grants and contracts include direct billing, advance payment or letter of credit with accompanying reporting requirements.

Every day the federal policy committees spew out new regulations affecting their programs.

Every day the federal policy committees spew out new regulations affecting their programs. The Cost Accounting Standards Board has been methodically covering all the costs of projects supported by Department of Defense funds and specifying regulations for charging and supporting such costs, including an elaborate disclosure statement required when the dollars of support reach a certain level. The laws regarding the Equal Employment Opportunity law and the Affirmative Action for Handicapped Workers have resulted in adding one or more positions to the university's budget to handle the control and reporting requirements. Safety regulations under the Occupational Safety & Health Administration have also added personnel to the university budget.

Conclusion

With such a variety of laws, rulings and manuals that are continually changing it can be seen that the university must assign personnel who specialize in this field to properly control, account, report and collect the funds in this section of their operations.

All university personnel, particularly the groups involved in administering activities funded by government grants and contracts, are looking forward to the day when the federal government finally completes standardization of requirements under federal funding. The requirements as finally evolved may be unpopular but they will, at the very least, have the virtue of unity.

Continuing Professional Education Requirements for National Accounting Organizations

Glenda E. Ried

Glenda E. Ried, CPA, is associate professor in accounting at the University of Toledo, Toledo, Ohio. A member of ASWA, AWSCPA, the AICPA, and the Ohio Society of CPAs, Ms. Ried has had several articles published in The Woman CPA and is a past editor of the column on Financial Statements. Professor Ried completed both her undergraduate degree and MBA from the University of Toledo. She is a past president of the Toledo Chapter of ASWA.

Ms. Ried's article summarizes the results of a survey initiated by the Education Committee of American Woman's Society of Certified Public Accountants. The Committee gratefully acknowledges the assistance of the Business Research Center of the University of Toledo.

The accompanying table of the status of CPE requirements, by states, was prepared by Mary E. Burnet, CPA, of the Rochester, New York, Chapter of American Society of Women Accountants. The table is based on data compiled by the Continuing Education Subcommittee, Education and Research Committee, American Woman's Society of Certified Public Accountants.

In 1969 the state of Iowa adopted a policy requiring registered accountants to furnish evidence of participation in continuing education. Since then forty-two states have adopted Continuing Professional Education (CPE) requirements on a mandatory or voluntary basis.

The National Association of State Boards of Accountance (NASBA) has published a *Model Provision for Required Continuing Education* and the AICPA has issued similar guidelines. Many states have adopted the NASBA model substantially as written. However, each state does have its own regulations governing program qualification, controls and reporting. Variations occur most frequently in the areas of control and reporting. In addition, few states are willing to accept programs offered in other states on a blanket approval basis.

A questionnaire was mailed to fifty-four state or territorial societies of certified public accountants or their state boards of accountancy, to determine program qualifications, advance approval, sponsors agreements and controls and reporting for regional conferences and national conventions of the organizations. Questionnaires were returned by 51 of the 54 (94 per cent) societies or state boards.

Programs of certain organizations automatically meet the requirements of the State Boards of Accountancy for CPE without advance review of the program. The AICPA and state societies of CPAs sponsor professional development courses designed for the practitioner. National Association of Accountants, and American Accounting Association, sponsor seminars and short courses. The quality of these programs seems not to be questioned. However, programs sponsored by other recognized organizations (accounting, industrial, professional, etc.) seem to be subject to interpretation. General guidelines have been established, yet subject matter of these programs is subject to review before giving advance announcement that they meet CPE requirements. It is fairly easy to meet the requirements of one state when attendees are residents of that state. It becomes another matter when a national accounting organization (American Society of Women Accountants and American Women's Society of CPAs) wishes to have the programs and technical sessions of its national convention qualify as to program, controls, and reporting for *all* states requiring CPE.

The first purpose of this article is to assist national organizations in qualifying their programs for continuing professional education to participants from *all* states and territories. Second, it is to assist them in meeting and carrying out all controls while the program is being held and the reporting requirements of the various states subsequent to holding the program.

Program Qualifications

For the majority of states the subject matter considered acceptable for programs and technical sessions is not listed, but rather stated that "the overriding consideration in determining whether a specific program qualifies is that it should be a formal program of learning which contributes directly to the professional competence of an individual...".

The National Association of State Boards of Accountancy lists in its publication, *Model Provisions for Required Continuing Education,* the following subject matters as acceptable *providing* they contribute to the competence of the practitioner:

Accounting and Auditing
Taxation
Management Services
Computer Science
Communication Arts
Mathematics, Statistics, Probability and Quantitative Applications in Business
Economics
Business Law

Functional Fields of Business: Finance, Production, Marketing, Personnel Relations, Business Management and Organization
Social Environment of Business
Specialized Areas of Induatry; e.g., Film Industry, Real Estate, Farming, etc.
Administrative Practice; e.g., Engagement Letters, Fee Structures, Personnel, etc.

In determining the relevance of subject matter, it is suggested that subject matter dealing with current developments in the accounting profession would be acceptable whereas subject matter relating to the knowledge basic to certification would be much less desirable, although acceptable in some cases.

Program qualifications to be met by national accounting and professional organizations are:

1. An outline of each program must be prepared in advance.
2. The program should be at least one hour in length.
3. The program should be conducted by a qualified instructor.
4. A record of attendance or registration is maintained.

The program outline can take several forms. An outline of the entire day's program listing time, topics and speakers must be prepared in advance. An outline of each presentation, in topical form, should be requested from that speaker along with a bibliography (required by a few states). Most states require the sponsoring organization to preserve these outlines for a specified time period. In some states the attendee is required to keep the outline.

One hour is defined as a fifty-minute contact period in all states except Kansas. The Kansas Board of Accountancy requires a *full sixty minute* hour of contact. So, in order to meet the requirements of all states, the program must extend to a full hour. A one-day program qualifying for eight hours of credit is generally any program which requires the participant to be absent from work for a normal working day.

A "qualified" instructor, discusion leader or lecturer is a person whose background, training, education or experience makes it appropriate for that person to speak on a particular subject matter.

Many state continuing education requirements specifically include technical sessions of recognized national professional accounting organizations provided they meet the guidelines, i.e., their programs are automatically deemed to meet the requirements of continuing education.

Advance Approval and Sponsor Agreements

Advance approval of an organization's program is not a prerequisite for that program to qualify for continuing professional educatoin. It is a service that gives sponsoring organizations and participants assurance that a program will qualify for credit. It also helps determine the number of hours of credit which may be granted. California's rules state "... if advance approval has not been obtained, the responsibility for establishing that a particular course is acceptable and meets the requirements rests solely upon the licensee."

Advance approval may be obtained from certain states by obtaining and filing a "Program Sponsor Agreement for Continuing Education." By filing this agreement prior to holding a convention or conference, the sponsoring organization acknowledges that they understand the continuing education rules and will abide by them. In return the sponsor may announce to members of its organization that the programs will qualify for so many hours of continuing professional education. The states from which a sponsor's agreement is available and where to write for it are:

Arkansas	-Arkansas Society of CPAs
California	- California State Board of Accountancy
Florida	- Florida State Board of Accountancy
Hawaii	- Hawaii Board of Accountancy
Nevada	- Nevada CPA Foundation
New Mexico	- New Mexico State Board of Public Accountancy
Ohio	- Accountancy Board of Ohio
South Dakota	- South Dakota Board of Accountancy
Tennessee	- Tennessee Society of CPAs
Washington	- Washington State Board of Accountancy
West Virginia	- West Virginia Society of CPAs

The Florida State Board of Accountancy introduced a revised system effective February 1, 1976. A *Sponsor Agreement Form* must be completed and filed whereby the sponsor acknowledges the rules and agrees to abide by them, and also agrees to complete the *Sponsor Attendance Form* for all courses given by that sponsor. An *Advance Approval Form* also must be filed giving the type of program, total contact minutes, course outline, and the instructor's biographical sketch. The Advance Approval Form combined with the Sponsor Attendance Form will enable the Florida committee to do a 100 per cent computer audit on all sponsor approved courses reported by Florida practitioners.

The following states have no sponsor's agreement, but the State Society of CPAs will review and approve programs for CPE credit. They are:

Alabama
Massachusetts
North Carolina
Rhode Island

Thus, fifteen states will grant prior approval. In eleven other states an organization may assure its membership of the acceptability of an out-of-state program even though that program has not been registered locally; however, the local state's implied acceptance tacitly assumes that only programs that meet the necessary requirements will be offered by the organization.

The remaining states will neither grand prior approval nor accept on a reciprocal basis (in advance) these programs. Regulations for these states do generally state,nevertheless, that programs, or technical sessions, of national accounting organizations are deemed to qualify for CPE providing all other requirements are met.

Therefore, on advance notices mailed to members of national professional accounting organizations it would be preferable to state that the program "meets CPE requirements" and, if desired, to state at the bottom of the notice "Approved for CPE by Alabama... Ohio... and... " naming those states that have granted advance approval.

Controls and Reporting

A certain amount of record keeping and responsibility falls upon the sponsoring organization. Most states require the sponsoring organization to maintain records as listed below for a specified number of years following the date each

Exhibit 1

ADVANCE APPROVAL

States with CPE Requirements	File Sponsor's Agreement	No Sponsor's Agreement but State Society will approve	Will Accept Without Pre-registration[1]	Technical Sessions of National Accounting Organizations are deemed to qualify
Alabama		x		x
Arkansas	x		x	
California	x			x
Colorado				x
Connecticut				x
Florida	x			
Hawaii	x			
Iowa				x
Kansas			Note 2	
Kentucky			x	x
Louisiana				x
Massachusetts[3]		x		x
Minnesota				
Mississippi				x
Missouri[3]	Note 4			x
Nebraska				x
Nevada	x			x
New Hampshire				x
New Mexico	x			x
North Carolina		x		x
North Dakota				x
Ohio	x		x	
Oregon				
Pennsylvania[5]				
Rhode Island		x	x	x
South Carolina				x
South Dakota	x		x	
Tennessee	x			x
Texas			x	x
Vermont[3]				x
Virginia			x	
Washington	x			
West Virginia[3]	x		x	
Wisconsin			x	x
Wyoming			x	x

[1] If given in another state and meets all requirements.
[2] "Can make notice that program meets Kansas regulations 74-9-2A and announce number of *full 60-minute* hours of contact in technical sessions"
[3] New programs effective in 1976.
[4] In development stage.
[5] To be determined in the future.

CONTINUING EDUCATION REQUIREMENTS BY STATES, AND EFFECTIVE DATES OF LEGISLATION

	Mandatory	Voluntary	Under Consideration	No Requirements
Alabama	1972			
Alaska	1980			
Arizona		1973	XX	
Arkansas		1975		
California	1973			
Colorado	1974			
Connecticut		1974		
Delaware				XX
Florida	1974			
Georgia		1976		
Hawaii	1975			
Idaho			XX	XX
Illinois		1975		
Indiana				XX
Iowa	1969			
Kansas	1974			
Kentucky		1976		
Louisiana		1974		
Maine				XX
Maryland	1976			XX
Massachusetts				XX
Michigan	1976			
Minnesota		1975		
Mississippi		1972		
Missouri			XX	XX
Montana		1976		
Nebraska	1975			
Nevada	1974			
New Hampshire	1974			
New Jersey		1976		
New Mexico	1976			
New York		1973		
North Carolina		1975		
North Dakota	1976			
Ohio	1975			
Oklahoma		1975		
Oregon	1975			
Pennsylvania		1971		
Rhode Island		1974		
South Carolina	1974			
South Dakota	1975			
Tennessee		1975		
Texas		1972		
Utah				XX
Vermont	1976			
Virgina	1975			
Washington	1973			
West Virginia		1976		
Wisconsin		1973		
Wyoming	1978			
District of Columbia				XX
Guam				XX
Puerto Rico				XX
Virgin Islands				XX

program is presented:

a. The date and location of the program presentations.
b. The names of each instructor or discussion leader
c. The listing of licensees attending *each* program presentation.
d. A written outline of the program presentation.

If an outline is required to be kept by the attendee (according to his or her state requirements) then said attendee should be able to acquire a copy of the outline and to be notified where it can be obtained. An alternative is to make copies available at the technical session.

It is preferable that attendance lists be maintained by state of residence because the number of years these attendance records must be kept range from two to seven years and vary by state (Exhibit II). In practically all instances, these attendance records are kept by the sponsoring organization. Some states require the attendance record of their licenses to be forwarded to the State Society or State Board of Accountancy (Exhibit II).

Three states (Hawaii, South Carolina and South Dakota) specify that written evidence (or a certificate) of attendance shall be issued to each attendee by the sponsor, with the suggested continuing education credit hours shown thereon.

It would be desirable to draft a statement to be *signed* by the attendees, the original to be kept on file by the sponsoring organization and a copy to be kept by the attendee for his or her purposes. This statement should show all pertinent information needed by the attendee for filing purposes and also fulfill the obligations of the sponsoring organization. See Exhibit III for an example of such a statement. If coffee breaks and/or luncheon break up the sessions, then the forms could be punched to record attendance at the various sessions. The signed statement would be turned in at the end of the day's sessions.

The sponsoring organization must keep these attendance records and other agreed upon information at a given location for the specified number of years.

Conclusion

The State Boards of Accountancy should encourage advance approval of programs by large sponsors. It encourages the sponsors to predetermine what type of courses will be offered and to maintain high standards of quality for those courses. It also suggests that the governing body of CPE programs, the state board of the state society, must take one of two courses of action. One suggestion is that all states with CPE requirements establish a Sponsor's Agreement if one is not already available. The second suggestion is that those states without a Sponsor's Agreement willingly accept programs on a reciprocal basis that are registered with other state boards and societies. The programs meet the AICPA and NASBA recommendations because that is an essential part of the Sponsor's Agreement.

California, Hawaii, Florida and Ohio have highly formal and sophisticated systems. Other state CPE governing bodies would be well advised to study these systems and NASBA recommendations and consider their adoption.

Exhibit II

ADDITIONAL REPORTING CONTROLS

State	Number of Years to keep records	Attendance Record to be forwarded	Certificate of Attendance Issued to Participant
Alabama	3	State Board	
Arkansas		State Society	
California	4	No	
Colorado			
Connecticut			
Florida	5	State Board*	
Hawaii	2	No	Yes
Iowa	3	No	
Kansas	2	No	
Kentucky		No	
Louisiana		No	
Massachusetts		No	
Minnesota			
Mississippi		No	
Missouri	4	No	
Nebraska	4		
Nevada			
New Hampshire	4 - 5		
New Mexico	4	No	
North Carolina			
North Dakota			
Ohio	5	No	
Oregon			
Pennsylvania			
Rhode Island	4	No	
South Carolina	4	No	Yes
South Dakota	4	State Board	Yes
Tennessee		No	
Texas		No	
Vermont		No	
Virginia	3	No	
Washington	4	No	
West Virginia			
Wisconsin	7	No	
Wyoming	5	No	

No reply given where spaces are blank.

* File *Sponsor Attendance Reporting Form* within 30 days.

Education

Continuing Education Opportunities for Accounting Faculty

Editor: Dr. Loudel O. Ellis CPA, CMA
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Guest Writer: This column was written by Dr. Gary L. Holstrum, CPA.

Dr. Holstrum is Associate Professor of Accounting at the University of Florida. He holds a B.A. and Ph.D. from the University of Iowa and a CPA certificate from the state of Texas. He has published widely in journals including The Accounting Review, The Journal of Accountancy, Management Accounting, the Journal of Accounting Research, and others.

Professor Holstrum is a member of various professional organizations and was chairman of the American Accounting Association Committee on Professional Continuing Education, 1975-76. This column presents his findings of selected continuing education opportunities available to accounting educators.

"Today. . .the number of scientific journals and articles is doubling. . .about every fifteen years. . .The United States Government alone generates 100,000 reports each year, plus 450,000 articles, books and papers. On a worldwide basis, scientific and technical literature mounts at a rate of some 60,000,000 pages a year." (Source: Alvin Toffler, Future Shock, 1970, p. 31).

"One of the hallmarks of a profession is a commitment to continuing education. In a world characterized by exploding knowledge and technology, such a commitment is essential if a profession is to continue to serve the public interest and be worthy of the high level of respect to which it aspires." (Source: "Statement of Members Responsibility for Continuing Education," drafted by the 1974-75 Committee on Continuing Education, and published in Accounting Education News, January, 1976).

The nature of the changing environment confronting accounting educators and the need for a strong professional commitment to adapt to these changes are clearly articulated in the publications from which the above excerpts were taken.

The American Accounting Association's statement on "Members Responsibility for Continuing Education" emphasizes that the mere passage of time can result in the onset of intellectual obsolescence. The statement establishes as a guideline that at least ten percent of a faculty member's time should be spent in activities which build, or at least maintain, intellectual or teaching capabilities.

The purpose of this article is to discuss various opportunities for accounting faculty to build these capabilities through participation in a wide spectrum of programs.

Opportunities at One's Own School

One of the most fruitful sources for faculty development is in formal academic courses offered through other departments at the faculty member's own school. Many schools offer courses which are rich in research methodology as well as those which provide excellent avenues for improving personal teaching effectiveness.

Faculty at various schools have successfully experimented with various forms of informal "bag-lunch" seminars or workshops where new ideas for research projects are introduced and evaluated, and the tentative findings of ongoing projects are presented and discussed. This provides an excellent vehicle for interdisciplinary interaction and for obtaining helpful guidance for projects during the crucial formative stages.

Programs Sponsored by the AAA

During the last few years there has been an increase in the number of courses and the level of participation in courses offered by the American Accounting Association. Several of these courses are offered each year in conjunction with the national meetings. Just prior to the last convention in Atlanta in August, 1976, the AAA sponsored the following eight continuing education courses:

1. Annual Accounting and Auditing Update.
2. Financial Statement Disclosure.
3. Reporting Results of Operations and E.P.S.
4. Workshop on Social Accounting.
5. Dollar Unit Sampling in Auditing
6. Regression and Discriminant Analysis for Accounting Research.
7. Auditors' Liability Workshop.
8. Research Appreciation.

In addition to these programs at the national meetings the Research Appreciation program was offered at the Mid-Atlantic Regional meeting and the Auditors' Liability Workshop was offered at the Southeast Regional meeting. This year the Task Force on Continuing Education, which succeeded the Committee on Professional Continuing Education, is attempting (1) to increase the number of programs offered on a regional basis and (2) to offer courses devoted to topics that are of interest to the special sections of the Association (e.g., tax, auditing, and public sector sections). Information about future AAA programs may be obtained by referring to the Accounting Education News, which is mailed to all AAA members, or by contacting the AAA Administrative Office, 653 South Orange Avenue, Sarasota, Florida 33577.

Programs Sponsored by Other Professional Associations

Numerous continuing education programs are offered throughout the U.S. by state CPA societies. A recent survey by George Gustafson, a member of the 1975-76 Committee on Continuing Professional Education, showed that thirty-four of the state societies permit accounting educators to attend their programs and courses free of charge or at reduced rates. However, in only nineteen states were these programs and courses attended by accounting educators to any significant extent. The AICPA has encouraged state societies to make continuing education courses available to educators completely free of charge. For most of its courses the AICPA will not charge cooperating state societies for Institute materials provided to educator participants. Details of these programs and courses are available through the individual state societies.

Continuing education programs and seminars are offered by many other accounting organizations, such as the National Association of Accountants, The Institute of Internal Auditors, the Financial Executives Institute, the American Society of Women Accountants and the Association of Government Accountants. The fees and policies toward educators vary considerably between these organizations. The faculty member should contact the organizations directly concerning courses and fees.

CPA Firm "In House" Programs

Public accounting firms often make available to accounting educators several types of their "in house" programs — including local programs, regional programs and staff training schools. The purpose of most local programs, which typically last from two to four hours, is to update staff on current professional developments. These local programs are beneficial because they allow educators to (1) build a rapport with local firm personnel; (2) gain exposure to current developments in areas where they have some basic knowledge; (3) cover various topics they might not be able to pursue on their own initiative; and (4) be involved in continuing education activities with little or no loss of classroom time.

Regional "in house" programs of accounting firms typically last from one to three days and are often similar to programs of the AICPA and state societies. These regional programs usually offer educators the opportunity (1) to delve deeper into areas of special interest; (2) to observe the best in-house seminar leaders and the latest teaching techniques, materials and equipment; and (3) to devote full attention to the seminar topic because of the away-from-campus environment.

The staff training schools typically involve a five to ten day treatment of basic topics. Participation in these concentrated programs allows educators to acquire fundamental knowledge which can provide a base for further in-depth development. Participating educators will be exposed to different learning environments, facilities and teaching methods over a more sustained period than with the local or regional programs. Faculty without public accounting experience can get an understanding of accounting and auditing work environments and techniques. This can be especially helpful in classroom teaching.

Faculty Internships and Residencies

Valuable continuing education experiences are available in public accounting, industry, and government through faculty internships, which typically last from two to five months, and residencies, which usually last from twelve to eighteen months. These programs are available either in local offices or in the national headquarters of the sponsoring organization.

A faculty internship in a local office of a CPA firm allows an educator to obtain an appreciation and understanding of the organizational structure and day-to-day operations of the firm, as well as the professional and personnel problems faced by the management of the firm. It allows the faculty member to develop a close working relationship with local office personnel, which can be a valuable resource for future teaching and research projects.

Internships or residencies in national headquarters of firms typically provide opportunity for educators (1) to study how firm policies are developed; (2) to participate in the preparation of the firm's educational materials, (3) to participate in research groups which are preparing firm responses to proposals of governmental and professional regulatory bodies; (4) to understand the differences and relationships between research by practitioners and by academicians; and (5) to observe and work with professional leaders who are in policy making positions.

Conclusion

The Task Force on Continuing Education of the American Accounting Association is currently working with the Educational Materials Exchange Committee (EDMAX), composed of the training directors of the largest accounting firms, in an effort to coordinate participation by educators in CPA firm in-house programs, internships and residencies. Many firms are now eager to have educators participate in some of their programs but wish to restrict participation to their own staff personnel in certain programs dealing with sensitive issues. The Task Force desires that these programs be more widely available and publicized to accounting educators. Because policies regarding faculty member participation in in-house programs vary considerably from firm to firm, educators who are interested in attending these programs may wish to contact several firms directly regarding details.

There is truly an abundance of opportunities for faculty continuing education. This discussion has covered only a portion of them. Today's professor might become nostalgic when being told that a professor sixty years ago needed only about twenty-five minutes a day to keep up with all the new material in the field. However, educators may find relief in the present situation by realizing that a professor only a few years in the future, according to the same assumptions about reading rate, etc., would need to read continously every hour of every day to keep up with all the new material being introduced in the same field.[1] The need for an accounting educator to be actively involved in continuing education is undeniable.

1 J.C.R. Licklider, "A Crux in Scientific and Technical Communications", American Psychologist (November, 1966), pp. 1044-1051.

Electronic Data Processing

The Computer & the Audit Trail

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The audit trail can be considered a continuous trail of evidence that links individual transactions to summary figures in the financial statements. It represents a system of documentation that makes it possible to trace the results of an individual transaction through the accounting records and into the financial statements or that makes it possible to take the results reported by financial statements and to trace the amounts back through the accounts to the basic transaction. In a manual system the audit trail takes the form of source documents, journals recorded in chronological order, ledgers that show the current balance, work sheets, and other files of information.

The introduction of computerized record-keeping has caused some changes in the form of the audit trail. In some instances the source documents remain unchanged and in those cases can be used as they are in a manual system. In other instances the source document as it is known in a manual system is eliminated. Some data-collection techniques can capture data through use of badge readers, tag readers, or key-driven operations and do not require existence of a formal source document beforehand. In these circumstances it may be helpful to attach a printing capability to the collection machine so that it can create a substitute trail.

The Relation of Audit Trails and Data Control Techniques

The use of an audit trail may vary depending upon the user. For the installation itself the audit trail may more properly be called a reconstruction procedure. For the use of the auditor these records provide a means by which results can be traced back to their original transactions. The calculation of control totals for data control can be combined with the generation and use of normal activity reports. For example, if real-time transactions are used to update a master file as they occur and are simultaneously being accumulated for an activity report, it is possible to use the totals of the activity report for a given time period to check the new balance of the master files at that same period. The combination of master-record balances at the beginning of a time period plus activity over the period as documented in an operating report for that time should provide an independent check of master records at the end of the time period.

These balancing operations can be done for each individual account in a given master file at the end of a specified period of time or for the entire file. The more detailed the checking facilities, the more costly the checking process, and the cost of maintaining more detailed control records must be balanced against the time required for reconstruction and the importance of individual record accuracy. In attempting to insure that the transactions are valid, a great deal of effort is expended to insure that transactions are valid and are processed against the right master files and to provide sufficient material for file reconstruction in those cases where it becomes necessary. In some cases the two objectives can be served by a single procedure. An example would be a transaction log or listing that can be developed as part of the processing of accumulating control totals.

A transaction listing can result from a logging operation in real-time systems or can be produced in a batch-mode application as a part of the control-total balancing operating. Frequently this transaction listing can also serve as an accounting or managerial report—for example, an inventory activity report, a cash receipts register, or a sales register, as illustrated in Figure 1. In a batch-mode operation the total of this listing can be compared against a batch control sheet on a daily or batch basis. At the end of an accounting period the control sheets can be used to balance against the accumulative or master files. As discussed earlier, real-time systems can also accumulate and produce transaction listings or logs that can serve the same function. In a real-time system, however, the balancing of transaction totals to master totals can be done continuously and automatically by the computer. Further, the control record can be generated by the system itself.

Transactions logs or listings serve multiple purposes. They can be used as a control and balancing tool; they can be used as an aid in reconstruction if necessary; and they can also aid the auditor without additional expense to the installation and thus serve as an excellent audit trail.

Replacement of Traditional Documents, Journals, and Audit Trails

Many records are no longer stored in hard copy that is intelligible to human beings. Data is stored instead in machine-readable format, and intermediate results are not printed. Changes in the recording media and the elimination of many clerical procedures have combined to eliminate many of the traditional audit trails by which individual records can be traced forward to final reports or back to the original transaction.

Most computerized systems eliminate the traditional chronological journal found in manual systems. These can be replaced functionally by the listing of transactions or preparation of activity reports. In a batch system where the transactions are grouped for a given processing period, the list can contain all transactions, sorted by account number or item number. In instances where the transactions are not sequentially ordered, a straight transaction listing is less useful. However, a technique of logging access to master records and the transactions that impact master records to produce a new balance can accomplish the same end. Most mechanized records or computerized records do not contain within the record an historical account of all changes, or postings, to the records of accounts involved. They show instead only the most current balance. Thus by keeping a log of all changes to account balances in on-line systems, it is possible to approximate the function of a ledger. It should be pointed out, of course, that this cannot be done without cost. Every line printed that is not necessary to calculate the new balance represents a cost incurred for the sake of documenting the transaction.

The approach of logging all entries to a given record is most useful in those instances where records are being updated with unbatched transactions. In any instance where a batch of transactions is maintained, the simple transaction listing (which can be a by-product of the editing and/or balancing process) represents the least expensive form of documenting transactions. Many applications produce various status and other management reports that document the contents of various computers at specified points in time. These reports can also serve to provide some part of the audit trail and to do so without additional cost. As shown in Figure 2, the audit trail can take several different forms.

The transaction log can be recorded on machine-readable records instead of printed records. This allows high-speed reorganization and use of the log records. The random occurrence of transactions in real-time systems and the lack of sequence in the resulting log makes the ability to sort and reorganize the transaction log efficiently especially useful for analysis of groups of transactions and for activity in specified accounts.

The particular provisions made in developing an audit trail should reflect the uses to which it will be applied. An audit trail represents much more than just a means for the auditor to trace transactions to the financial statements and back. It is also a process by which departmental charges and customer

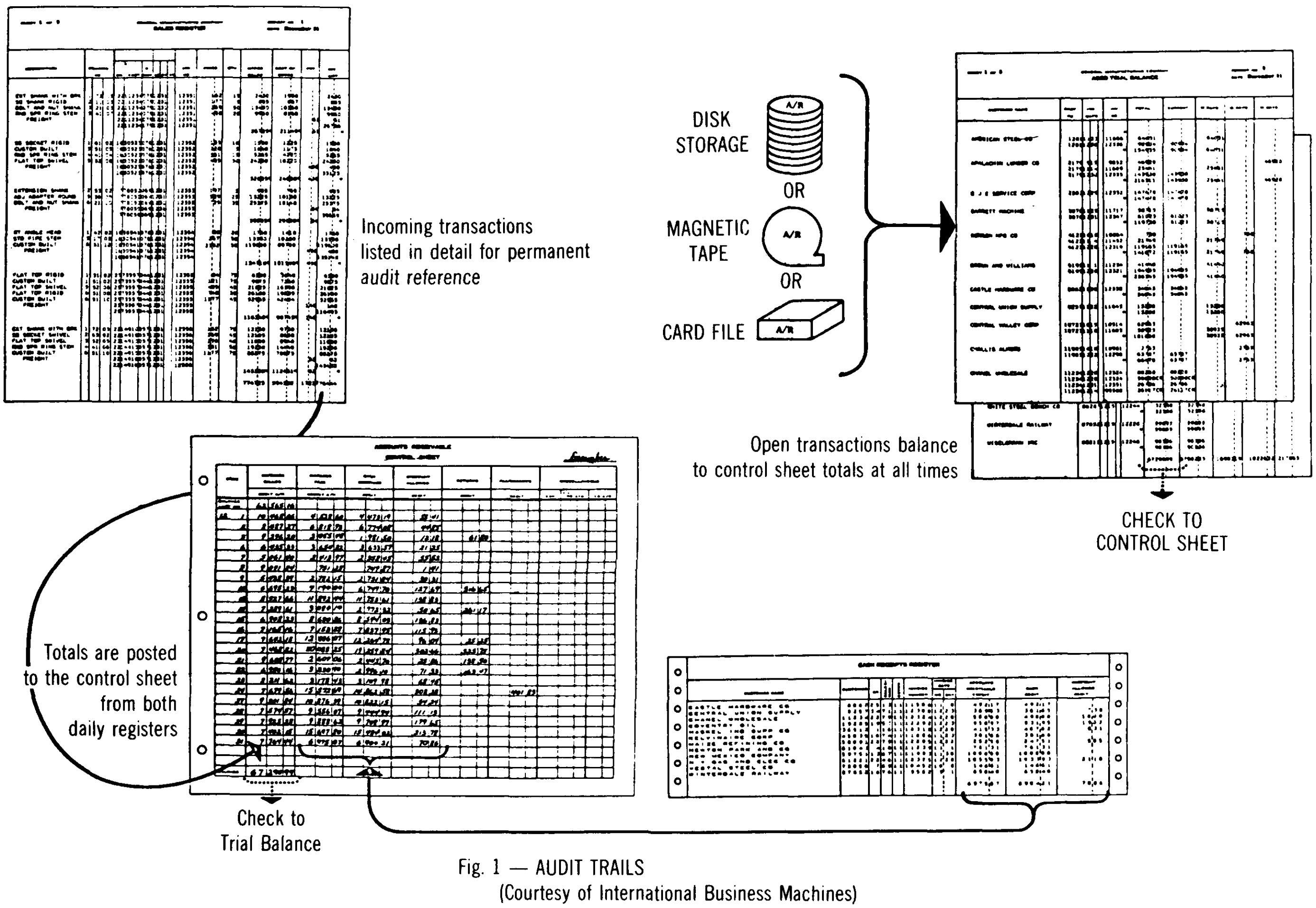

Fig. 1 — AUDIT TRAILS
(Courtesy of International Business Machines)

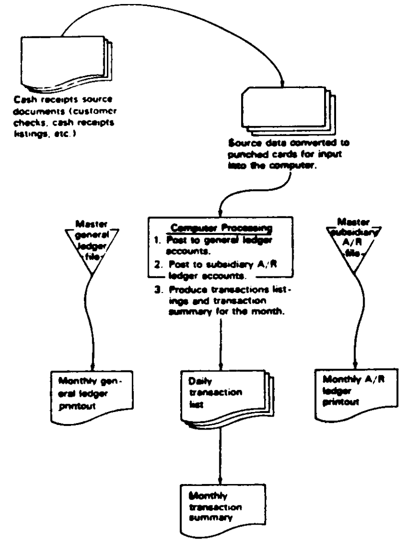

Fig. 2 — AUDIT TRAIL DOCUMENTS
(Courtesy of McGraw-Hill Book Co.)
AUDITING CONCEPTS & METHODS BY
WILLINGHAM & CARMICHAEL

charges can be traced back to transactions prompting them. It is a method by which management can break summary totals into their component parts for varied analysis and operational evaluation. Last but certainly not least, the audit trail provides a technique by which records can be reconstructed, should unexpected errors or destruction of data occur.

Legal Requirements for Audit Trails

Certain legal requirements also dictate the form and extent of audit trail techniques. Of particular importance are the requirements of the Internal Revenue Service. Section 6001 of the Internal Revenue Code of 1954 requires that "every person liable for any tax imposed by this title or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or delegate may from time to time prescribe." Section 2 of Revenue Procedure 64-12 indicates that "the inherent nature of ADP (automatic data processing) is such that it may not be possible to trace transactions from source documents to end results or to reconstruct a given account unless the system is designed to provide audit trails."Thus Revenue Procedure 64-12 provides, guidelines for record requirements to be followed in cases where part or all of the accounting records are maintained within automatic data processing systems."

Revenue Procedure 64-12 has been modified by Revenue Ruling 71-20. Revenue Ruling 71-20 adds the retention of machine-readable records to the hard copy requirements of Revenue Procedure 64-12. Ruling 71-20 holds that punched cards, magnetic tapes, disks, and other machine-sensible data media used for recording, consolidating, and summarizing accounting transactions and records within a taxpayer's automatic data-processing system are records within the meaning of Section 6001 of the Internal Revenue Code 1954 and Section 1.6001-1 of the Income Tax Regulations and are required to be retained as long as the contents may become material in the administration of any internal revenue law.

Advanced Systems and the Audit Trail

One of the problem areas frequently identified with real-time systems is the potential loss of the traditional audit trail. This is usually translated to mean the absence of a hard copy source document. However, the question of available hard copy source documents is really not a matter of real-time versus batch-processing systems or even of remote input-output stations but rather a matter of the data-recording technique chosen. Thus many transactions initiated at remote locations (whether they are going to be batched or to be processed in a real-time environment) are recorded on a traditional source document before transmission to the computer. In these instances the auditor must work out new logistics for relating transactions as they appear in the processing activities to the source document, but he does have the traditional source document for reference. In other environments, however, much effort has been expended by the installation to eliminate the relatively time-consuming and error-prone process of manual recording and subsequent transcription of the data into machine-readable form.

In many real-time applications the initial recording of the transaction is done directly on the terminal transmitting to the central processing unit. In these circumstances the principal protection against destruction of the audit trail is intentionally to cause the recording process itself to produce some hard copy. This can be done by attaching a printer/typewriter capability to the computer terminal/or by requiring some other manual logging procedure at the terminal.

There is a distinction between the techniques that can be instituted to provide a historical audit trail and those techniques that are instituted to detect and prevent errors from entering the system. The use of a transaction log at the installation to record all transactions transmitted to the central location can be used subsequently to validate transactions that were entered into the system and to provide an historical after-the-fact audit trail and batch control for all transactions to particular classes of master records. This transaction log, however, may not be a useful tool for preventing errors from entering the system, although it may help subsequently to identify those errors that have occurred. Techniques such as immediate feedback to the operator of a terminal have much more value as error prevention techniques.

Although the form of the audit trail is changed in real-time systems, it can still exist in a very usable form. Management of an installation finds it absolutely necessary to be able to reconstruct records or trace the relationship between transactions and their impact on certain operating data. In addition, there are the legal requirements imposed by various government agencies such as the Internal Revenue Service that require the retention of certain historical information. In some instances, in fact, the audit trail provided by a well-designed real-time system can be used to even greater advantage by the auditor than the previously existing trails.

An easy reconstruction technique that the auditor can use to advantage is the procedure by which master files are dumped periodically for reconstruction purposes. Essentially each copy or dump of a file represents the capture of a particular generation of that data file. By comparing two generations of the file and analyzing all of the differences between the two balances of each account, the auditor can determine whether the differences between the first and second balance are supported by legitimate transactions or whether they contain questionable changes. Further, this procedure also immediately identifies the addition of new records within a master file or the deletion of old records and allows the auditor to verify the legitimacy of any new entries.

In those instances where the system itself generates a transaction (as in the automatic reorder function in an inventory control system), it is important that the system document the existence of that machine-generated transaction by producing some hard copy memorandum that can be verified by an independent check of the activity. It is precisely this ability of a real-time system to generate a transaction on its own, or the ability of an operator to record a transaction on a terminal without producing a printed copy of the transaction, that leads to much of the concern regarding the loss of the traditional audit trail. In those instances where traditional source documents are eliminated, additional control procedures should be instituted to control access to and use of the terminals. These techniques were discussed in the previous section.

Many installations, in recording their transaction logs, include both the user code and the terminal identification on all logged transactions. A transaction log not only makes reconstruction of the master files possible, but it can also be used to provide documentation for individual transactions. Thus the transaction log can be sorted daily by part number or user code or terminal code to print daily transaction journals and forms that will facilitate verification of the previous periods' activities. A transaction log can also be summarized by type of transaction to provide or confirm summary information for control accounts. Not only can a transaction journal for all transactions of a given type be printed, but these transactions can also be sorted by master record or control field to print a summary of all the activity occurring to a particular master record (or account) for a given period.

Others Uses of Audit Trail Techniques

The difficulties of associating individual source documents or transactions with specific summary records result not from real-time processing but from the techniques of updating an integrated file in which one transaction is used to perform all updating to all affected files simultaneously. The problem is one of ordering the source documentation for those transactions in such a way that they are easily accessible to the auditor without requiring a search through thousands of documents that may be stored in a sequence other than that which is currently needed. The solution to this particular problem comes not with increased documentation of the transactions but with a carefully planned method of organizing source documents so that they are more easily retrieved. It might be noted that the concept of a transaction log discussed in an earlier section of this article is one in which this problem can be approached.

Transaction logs that contain within the data stored identifying information such as the transaction date, the transaction number, and the files to which a transaction is posted allow the auditor to use the computer to reorder that information and to group it at his convenience. Thus if an auditor wants to look at all of the transactions posted against a particular account on a particular day, the transaction log can be used to produce a listing of that information. As part of that listing the specific physical location of the supporting documents for the transaction can be indicated. The real-time system introduces the possibility that the initial source document may not exist. In these instances, the transaction log can itself become the system's record or transaction documentation. On the other hand, many systems use terminals that produce hard copy records of transactions as they are entered, and these documents can be stored at appropriate locations where they are accessible and useful to the user.

While the form of the audit trail may change substantially, there is no reason why the audit trail should disappear or become unusuable. If careful thought is given to the needs for audit trails at the time the system is being designed, they can be implemented in the system. In most instances the introduction of sufficient controls and records to provide an adequate audit trail benefits far more than the auditor. Usually the same techniques that provide adequate audit trail for the auditor's purposes are equally valuable to the installation for its own control and/or reconstruction purposes.

Financial Statements

The Current Status of Human Resource Accounting

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Guest Author

Dr. Jacob B. Paperman, CPA, is a member of the faculty of the Department of Accountancy at Miami University and has had articles published on current value accounting, cost accounting, and human resource accounting in various professional journals. He is a member of AICPA, AGA, AAA, NAA, and the Ohio Society of CPAs.

The Current Status of Human Resource Accounting

Although the theory of Human Resource Accounting (HRA) was developed by Roger H. Hermanson in 1964, the subject received little attention outside of academic journals until the summer of 1969. At that time, HRA was introduced to practicing accountants with the announcement that the first such system had been initiated at the R.G. Barry Corporation. During the following years, the innovators of the R.G. Barry installation (Brummet, Flamholtz, Pyle, and Likert) authored numerous articles regarding this experimental application. They predicted that HRA, in addition to being a useful management tool, would ultimately be reported in audited financial statements and prove to be important information for investors.

In the ensuing years, HRA received considerable attention regarding its theoretical usefulness to managers and the propriety of including such information in the published financial statements. The Touche, Ross and Co. Montreal Office reported experimenting on an internal application. Several articles also indicated that experiments had been conducted by banks and a study of force-loss cost analysis had been conducted at the Human Resource Laboratory of the American Telephone and Telegraph Company. The facts disclosed about the R.G. Barry system and the other internal programs were limited to general comments and suggestions about improved reporting of personnel turnover. Few, if any, factual statements have appeared about other attempts to test or implement a Human Resource Accounting System.

The best summarization of the results of internal applications of HRA appeared in Flamholtz's book, *Human Resource Accounting*. In addition to applications that had been reported in the literature, Flamholtz discussed his efforts to develop pilot systems for an insurance company and the CPA firm of Lester Witte & Company. The results reported indicated existing difficulties in determining the value of the services of employees, obtaining acceptable mobility data, and a need to change the valuation model being tested. Apparently, the American Accounting Association's 1974 Committee on Accounting for Human Resources was dissatisfied with the paucity of reported results. The Committee expressed the opinion that few companies were ready to establish a human resource accounting system because no financial benefits had been demonstrated. It further suggested that the few companies that had attempted such programs had not published the results of the experiments because they were unsuccessful.

Since little was published on the status of HRA applications, the author initiated correspondence with several major industrial firms, national CPA firms, and the American Institute of Certified Public Accountants. From the replies received and an interview with the Treasurer of the R.G. Barry Corporation, Mr. Richard Burrell, facts were obtained about the current status of HRA in both internal and external reporting systems.

Internal Applications

Thirteen companies (figure 1) reported (in an unpublished doctoral dissertation) to have experimented with an internal application of HRA were queried in late March of 1976 on the status of the project and information regarding the published or unpublished results of the experiment. As of July 1976, seven firms had replied. Three of this group indicated their activity had been limited to financial support of the project at the University of Michigan, inquiry of interest in the program, and provision of data to a dissertation candidate. One company indicated no record of any participation in the project while the remaining three that reported participation stated the effort was primarily involved with personnel activity and not integrated within the accounting system. Two of the companies that had participated reported that the analyses of the results indicated that many questions must be answered before their efforts could be applied to a routine accounting operation. It was also stated that the experiments had been halted pending further research on the basic concepts and problems of allocation and measurement.

HRA in Financial Statements

Twelve national certified public accounting firms (figure 2) were queried to determine if they had any established policy or research on the subject of HRA. Five companies sent written replies and two others gave negative answers during a telephone follow up. The only firm that had a stated policy was Arthur Andersen & Company. Respondents from three of the firms gave their personal opinions that HRA was unacceptable under APB No. 17.

Arthur Andersen & Co. had presented its policy on HRA in *Objectives of Financial Statements 1972.* In this publication, the firm established that an asset should have the characteristics of utility, scarcity, and exchangeability. In accordance with these criteria, the paper concluded that tangibles such as human resources and goodwill are not assets. However, it recognized that for some companies the charging of large expenditures for human resources to earnings on a current basis may distort income reported in the short term. A solution to this problem would be to report such expenditures separately on the income statement and possibly include a statement of intangibles supplemented with a narrative of important facts. Thus, while the human resources and other intangibles are eliminated from the balance sheet, the information is made available to the external users so they may judge management's performance in this critical area.

A leading proponent for the external use of HRA, Marvin Weiss, has inferred that the capitalization of training by Electronic Data Systems, the Milwaukee Braves, and Flying Tigers are examples that the concept of HRA has been considered and accepted in the past. The Braves and Flying Tigers had ceased this procedure in 1964 and 1969 respectively, a period before HRA was even discussed in accounting literature. The R.G. Barry Corporation, the only company to present pro forma HRA statements in its annual reports, discontinued the HRA system in 1974. This action was taken because the top management of the company was of the opinion that the firm did not possess the resources necessary to accomplish the continued development required for HRA to become an effective management tool at the operating level. Mr. Burrell was of the opinion that the concept is valid but will not move towards general acceptance until the basic theory is more clearly stated, the measurement problem is solved,and the information provided is demonstrated to be reliable. These actions are not expected to receive any attention until the more pressing problems such as leasing and accounting under inflation are resolved by the FASB.

Figure I
Firms Questioned
On HRA Experience

American Airlines
American Telephone & Telegraph
The Budd Company
General Motors Corporation
General Telephone & Electronics
Mobil Oil
PPG Industries
Rockwell International
Sherwin-Williams
Texas Instruments
Uniroyal
Western Electric
Westinghouse Electric

Figure 2
National CPA Firms
Queried on HRA Policy

Arthur Andersen & Co.
Ernst & Ernst
Alexander Grant & Co.
Haskins & Sells
Hurdman & Cranstoun
Laventhol & Horwath
Main LaFrentz & Co.
George S. Olive & Co.
Peat, Marwick, Mitchell & Co.
Price Waterhouse & Co.
Touche, Ross & Co.
Arthur Young & Co.

With the discontinuance of HRA by the R.G. Barry Corporation it appears that actual implementation by industrial firms has ceased as no record could be found of any company, in the United States or Canada, that was utilizing an HRA system and/or reporting HRA information in published financial statements. This was supported by a study of the utilization of HRA in the professional sports industry by Philip E. Meyer in 1973. This study revealed that the sports industry, a prime candidate for HRA, had no general techniques to measure or report the cost of human resources. The general lack of interest in HRA in published statements is further evidenced by Gyan Chandra's study of the information needs of security analysts which disclosed that HRA information was the item considered least useful in the investment decision.

Several of the major arguments against the use of HRA in financial statements are:

1. Human resources do not meet the criteria of ownership required of an asset.
2. Reporting of humans as assets would have an unfavorable effect upon employee morale.
3. The measurement of the value of human assets is entirely subjective and incapable of verification.
4. Expenditures for specific training measurement of human asset value are either unacceptable under the theory of HRA or Generally Accepted Accounting Principles (GAAP)
5. The information would be misleading or confusing to the readers of financial statements as they have had no experience or standards upon which to evaluate the data.
6. No operational system exists for implementation.
7. Accounting must resolve other and more pressing problems.

The counter arguments for HRA generally include:

1. Accounting in respect to leases stresses the economic substance rather than the legal form.
2. No evidence exists to prove reporting an employee as an asset will be dehumanizing and several motivational theories suggest it may prove beneficial.
3. Accounting information should be relevant with less stress on objectivity and verification.
4. Expenditures for specific training will produce future increases in profits, and to expense such items is a violation of the matching principle.
5. It is the accounting profession's responsibility to introduce new practices to improve the relevance of the reports and to educate the users of the reports regarding the implications of the changes.
6. The continued use of the principles of conservatism and refusal to capitalize human resource expenditures results in an over-statement of future income and

a false appearance of improved operations.

Summary and Conclusions

The theory of HRA is based on elimination of ownership as a prerequisite characteristic of an asset and the utilization of value accounting. This theory was brought into an operational installation through Rensis Likert's, a behavioral scientist, attempt to integrate HRA with his concepts of participatory management. The system that was initiated at R.G. Barry in 1966 was designed for internal usage. However, the company reported the results in pro forma statements in its 1969 through 1973 annual reports. These statements carried the following note because it was recognized that HRA was not inherent in generally accepted accounting principles.

The information presented on this page is provided only to illustrate the informational value of human resource accounting for more effective internal management of the business. The figures included regarding investments and amortization of human resources are unaudited and you are cautioned for purpose of evaluating the performance of this company to refer to the conventional certified accounting data further on this report.

Although several valuation models have been developed, measurement is still the primary obstacle to an effective application of HRA. None of the cost models proposed are in conformity with the economic valuation concept of the theory. None of the economic models recommended are acceptable under generally accepted accounting principles. In addition, none of the models have yet been tested to the extent required to ascertain their reliability or usefulness.

The final results of the initial applications of HRA for internal usage have not been adequately reported for analysis by the profession. In addition, neither the AICPA nor the CICA has considered the subject of sufficient importance to study its possible application in published financial statements. Apparently, Arthur Andersen & Company is the only national CPA firm to have established a policy regarding human resources. It has recommended that human resources should be excluded from consideration as assets as they lack exchangeability. If the reporting of large expenditures is necessary, Arthur Andersen recommends that it be accomplished in a special statement.

For each argument against HRA's extension to financial statements, a counter argument exists. The basic issues center on the definition of an asset, use of current value accounting, objectivity, problems of measurement, and the usefulness of data. The accounting profession's current lack of agreement on the objectives and basic principles of accounting is the primary hinderance to the acceptance of HRA and any theory formally derived through deductive reasoning. In the almost 500 years since Pacioli wrote the *Summa,* accountants have still not been able to agree on such a basic issue as the definition of an asset.

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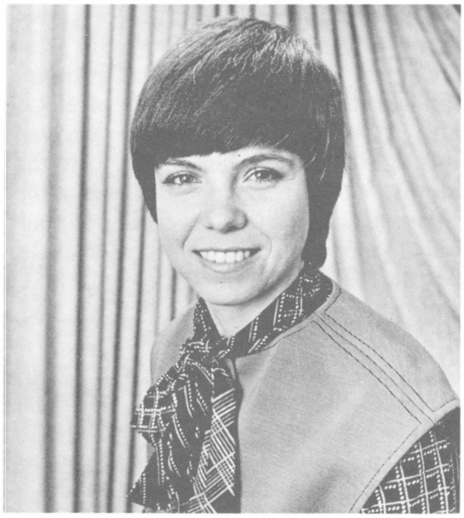
Tax Forum

A Big Change in Estate and Gift Taxation



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On October 4, 1976, President Ford signed into law the most comprehensive piece of tax legislation in over twenty years. The Tax Reform Act of 1976, the result of over three years of intensive effort by the House Ways and Means Committee and the Senate Finance Committee, is intended to encourage economic efficiency and growth. Although the Act is comprehensive, it does emphasize such areas as tax sheltered investments, business related individual tax deductions, estate and gift taxes, and U.S. taxation of foreign income.

Because this Act changes so drastically estate and gift taxation and because these changes affect us all (either now or in the future), this article provides a summary of the major Act provisions in this area.

General

Starting in 1977, fewer estates will pay federal estate tax but those that do will probably pay more. A principal goal of Congress was to exempt from transfer taxation families with relatively little wealth, while families with greater wealth will pay higher taxes than before.

Unification of Estate and Gift Taxes

Congress changed the separate structures for estate and gift taxes into a single unified tax structure to ensure that tax-payers pay approximately the same tax whether they give away all assets during their lifetime or wait until death. Under prior law, an estate tax was imposed on transfers at death and a gift tax imposed on lifetime transfers. Each tax had separate exemptions and progressive rate schedules, with the gift tax rates being three-fourths of the corresponding estate tax rates.

For gifts and transfers at death after December 31, 1976, the Act combines the gift and estate taxes by providing a unified rate schedule on the basis of cumulative lifetime and deathtime transfers. The lowest effective rate (after considering the new unified credit) is 32 percent and the highest is 70 percent for cumulative taxable transfers in excess of $5 million.

Unified Credit in Lieu of Specific Exemptions

Under prior law, there was a:

- $60,000 specific estate-tax exemption (a deduction from the gross estate to arrive at the taxable estate), and
- $30,000 lifetime gift-tax exemption.

Congress repealed these exemptions for estates of decedents who die after December 31, 1976, and for gifts made after December 31, 1976. However, the $3,000 annual gift tax exclusion per donee is still in effect.

The Act replaced the exemptions with a $47,000 unified credit against the estate and gift taxes for gifts made after December 31, 1980, and for estates of decedents who die after December 31, 1980. There is a phase-in of the $47,000 credit over a five-year transitional period for:

- Estates (the unified credit is $30,000 in 1977 increasing to $47,000 in 1981).
- Gifts (the same credit applies except for gifts made in the first six months of 1977, the credit is limited to $6,000).

The credit is first applied against the gift tax and the balance is available to reduce the estate tax. The $47,000 credit for 1981 can be roughly equated to a $175,000 exemption.

Computation of Post-1976 Estate and Gift Tax

After 1976, gift tax payable is computed as follows:

- A tentative tax under the unified rate schedule on the total cumulative taxable gifts (including pre-1977 gifts),
- Less a tentative tax under the unified rate schedule on the total cumulative gifts for all prior periods,
- Less the unified tax credit not used in prior periods.

The estate tax payable is computed as follows:

- A tentative tax under the unified rate schedule on the sum of the taxable estate and adjusted taxable gifts (taxable gifts made after December 31, 1976 other than those included in the gross estate),
- Less the gift tax on gifts made after December 31, 1976.
- Less the unified tax credit not previously used,
- Less other allowable credits (for example, state death tax credits).

New Tax on Generation-Skipping Transfers

Under prior law, the interest of beneficiaries in property not amounting to outright ownership was not subject to estate tax when the beneficial interest expired. For example, it was quite common to create a trust for a child and grandchild with the income available to the child for life. No estate was due on the child's death when his beneficial interest terminated in favor of the grandchild.

The Act provides that after 1976, this type of transfer will result in a new "generation-skipping" tax. The value of the trust at the child's death will be part of his total tax base at his death. The other parts of the tax base will be any prior generation-skipping transfers, his lifetime taxable gifts, and his taxable estate. A tax will be computed on this tax base using the unified tax rate. The generation-skipping tax provisions are intended to achieve the same tax results as if the assets were transferred out-right to each successive generation.

On generation-skipping transfers to grandchildren, there is a $250,000 exclusion for each child who has children. If a grandparent has two children, both of whom have children, the exclusion is $500,000; if only one of the children has children, the exclusion is $250,000.

The transfer need not involve a trust to result in a generation-skipping tax. The rules apply to life estates and remainders and most other trust equivalents that split the beneficial enjoyment of assets between generations.

Some generation-skipping arrangements potentially subject to this tax may avoid the tax in certain instances. For example, a beneficiary may be able to disclaim his beneficial interest and avoid the generation-skipping tax. Other ways of avoiding this tax require more careful planning when the initial transfers are made.

Generally, transfers in trust that were irrevocable on April 30, 1976, will not be subject to these rules. Estates of individuals who die before 1982 under a will existing on April 30, 1976 (and not amended therafter to increase the generation-skipping) will not be subject to these rules.

Disclaimers

A disclaimer is when a recipient of an interest in property irrevocably gives up his interest before enjoying its benefits. The person disclaiming is treated as having never owned the interest in the property.

Under prior law, whether a disclaimer was effective depended greatly on whether it qualified under local law. As a result, there was little uniformity in determining what was an effective disclaimer for estate and gift tax purposes.

The Act provides a uniform rule for disclaimers in estate, gift and generation-skipping taxation that affects all transfers made after 1976. Generally, a qualifying disclaimer must be made in writing within nine months after the day of the transfer that created the disclaimed interest. Also, the person disclaiming must not have received any benefits from the property during this period.

Increase in the Estate and Gift Tax Marital Deductions

Congress felt that no estate tax should be imposed on small estates, so they increased the amount a person can pass tax free to his/her spouse at death. After 1976, the estate tax marital deduction is limited to 50 percent of the adjusted gross estate or $250,000, which ever is greater.

In addition, the gift tax marital deduction was restructured to provide more flexibility in transfers between spouses. After 1976, the first $100,000 of lifetime gifts to a spouse qualifies for an unlimited gift tax marital deduction. Gifts from $100,000 to $200,000 are fully taxable. Thereafter, the deduction allowed is 50 percent of gifts exceeding $200,000.

Carryover Basis

Under prior law, the tax basis of property passing from a decedent to his beneficiaries was generally the property's fair market value at date of death (or alternate valuation date). This basis was referred to as "stepped-up basis."

The Act provides that property inherited from a decedent after 1976 will generally have a new carryover basis equal to the decedent's basis just before death. However, to cushion the effect of this dramatic change, assets in the decedent's estate (if owned on December 31, 1976) will be stepped-up for appreciation from date of acquisition to December 31, 1976. This step-up is allowed only for determining gain from a later sale of the asset.

This so-called fresh start is determined in two ways:

- For marketable securities, the increase is based on December 31, 1976 fair market value.
- For all other carryover basis property, a special rule using a given formula must be used. Generally under this rule, appreciation is assumed to have occurred evenly over the period from date of acquisition to date of death. Only the ratable appreciation before 1977 is an increase to the decedent's basis. Also, the basis of property is increased by the federal estate and state inheritance taxes paid on the net appreciation since December 31, 1976.

The fresh start basis adjustment and the estate taxes paid on appreciation after 1976 cannot increase the basis of the asset above its estate tax value.

The new carryover basis rules do not apply to certain assets, such as life insurance and the income in respect of a decedent.

Executors are required to furnish the Internal Revenue Service and the beneficiary with information on carryover basis property.

Gifts Made Within Three Years of Death

Under prior law, gifts within three years of death were presumed to be made in contemplation of death and were included in the decedent's estate unless the executor could prove otherwise.

The Act eliminates this rebuttable presumption and provides that all gifts (exceeding the $3,000 annual exclusion) made within three years of death and after December 31, 1976, automatically be included in the estate.

Under prior law, one tax advantage of gifts was that gift taxes paid reduced the taxable estate remaining on the donor's death. Under the Act, this no longer applies for gifts made within three years of death. Taxes on these gifts will be grossed up in the donor's taxable estate.

Jointly Owned Property

Under prior law, the entire value of property owned in joint tenancy was included in the decedent's gross estate except for amounts attributable to consideration furnished by the surviving spouse.

The Act replaces this "consideration furnished test" with a fractional interest rule where the property is held by the husband and wife with the rights of survivorship. Under this rule, where a joint tenancy is created after 1976 by a transfer subject to gift tax at the time of creation, 50 percent of the property will be included in the estate of either joint-tenant upon his or her death.

Retained Life Estate in Stock

Congress felt that voting rights are a significant attribute of owning corporate stock. In order to overcome a Supreme Court decision, the Act provides that after June 22, 1976, any person who gives away stock but who retains the voting rights will have that stock included in his estate upon death.

Exclusions for Qualified Retirement Benefits

Under prior law, an exclusion from the decedent's gross estate was provided for the value of a survivor's annuity payable to a beneficiary other than the executor and attributable to employer conributions to certain qualified plans.

However, this exclusion did not apply to individual retirement accounts or to H.R. 10 plans.

The Act provides that after 1976, the value of the survivor's interest in an individual retirement account, in an individual retirement annuity, and in certain retirement bonds and H.R. 10 plans is excluded. However, all lump-sum distributions from qualified plans are no longer excludable from the gross estate.

So that residents of community and separate property states would be treated as equally as possible for federal tax purposes, a change was made to benefit the residents of community property states. When an individual dies leaving a survivor's annuity in a qualified plan to someone other than the decedent's spouse, the surviving spouse will no longer be treated as making a gift of her community property interest attributable to employer contributions.

Orphans' Exclusion

After 1976, an estate can deduct an amount of property that passes to a decedent's minor child, if there is no surviving spouse and the child has no known surviving parent. This deduction is limited to $5,000 times the number of years the child is below twenty-one years old. For example, if a child is fifteen years old when his surviving parent dies, the estate is allowed a $30,000 orphans' exclusion.

Special Valuation for Qualified Real Property

Under prior law, all property included in the gross estate was valued at fair market value at the date of death (or the alternate valuation date). Normally, the property's highest and best use, rather than its actual use, was used to determine its fair market value. To provide relief for farmers and owners of other closely-held businesses, the Act provides that in certain cases real property can be valued at its current actual use. Generally, the property must be used for farming (although it may also be used in a trade or business other than farming). Certain percentage tests must be met, and the decedent or his family must have used the property for that purpose for a period of years before the decedent's death.

The relief is provided by a maximum reduction (up to $500,000) in the estate tax valuation of qualifying real property. The property must pass to a qualified heir of the decedent. Premature disposition of the qualified real property to outsiders or cessation of the qualified use results in a recapture of the benefits resulting from this special valuation (full recapture during the first ten years and partial recapture between the tenth and fifteenth year after the decedent's death).

Since special valuation rules do not apply to property that is given away, it may be wise to retain qualifying property. Investments in additional qualifying property might be advisable in certain cases.

Extensions of Time to Pay Estate Tax

Under prior law, there were two ways to extend estate tax payments for up to ten years. However, more relief was needed for estates composed largely of assets not easily convertible to cash, whether or not they constituted an interest in a closely-held business.

The Act provides this relief for estates of individuals who die after 1976 by:

- Replacing the former "undue hardship" reason for extension up to ten years with one based on "reasonable cause," thus making extensions easier to obtain.
- Continuing present rules that allow the estate tax attributable to a closely-held business (where its value equals either 35 percent of the gross estate or 50 percent of the taxable estate) to be paid in ten annual installments, and
- Providing a more lenient provision where the percentage tests required for the closely-held business extension cannot be met. If the interest in the closely-held business is 65 percent of the decedent's adjusted gross estate, the tax attributable to the closely-held business can be paid over a fifteen-year period. During the first five years, only interest is paid. The rules for combining businesses to meet the 65 percent test were relaxed so that if a decedent owns a significant interest in several businesses, he can aggregate these interests to qualify for the extension. A special 4 percent interest rate is allowed on the extended estate tax attributable to the first $1 million of closely-held business property.

Requirements for Filing Quarterly Gift Tax Returns

Under prior law, quarterly gift tax returns had to be filed if any gift exceeded the annual $3,000 gift tax exclusion per donee. Because this rule required that gift tax returns be filed even for very small taxable gifts, the rule was changed.

After 1976, no quarterly gift tax returns need be filed until the aggregate taxable gifts exceed $25,000. Thus, if a donor makes a $10,000 taxable gift each quarter, a gift tax return is not due until the third quarter when the total taxable gifts exceed $25,000. If there are any taxable gifts for the fourth quarter of taxable gifts for the three previous quarters not reported, a return must be filed.

Miscellaneous

The Act also provides these additional changes, having limited application:

- Selling expenses may not be used to offset the sales price on sale of property by an estate or trust in determining the gain or loss if thes have also been deducted for estate tax purposes. This is effective for taxable years ending after October 4, 1976.
- After 1976, if the Internal Revenue Service proposes to adjust the values reported on the estate, gift or generation-skipping tax return, the taxpayer, on written request, may get a written statement explaining the proposed increase.
- For a federal tax lien to be valid against subsequent purchasers, it must be filed now in a public index of filed tax liens that will be kept in the Internal Revenue Service district offices. This is in addition to the old requirement that the tax lien be filed in the public records. The new law is effective either 120 or 270 days after the date of enactment, depending on when the lien was filed.

Conclusion

The estate and gift tax changes under the Tax Reform Act of 1976 are far-reaching and will affect virtually every estate plan. In many cases, new provisions drastically narrow the advantages of what were once carefully constructed estate plans. Estate plans will therefore need to be evaluated and possibly revised to ensure that individuals profit from these provisions and that their goals are met.

Theory & Practice

1976 Standards, Rules and Statements

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Remember 1975, particularly the last few months of it, when it seemed that there was a contest going on between the Office of the Chief Accountant of the Securities and Exchange Commission and the Financial Accounting Standards Board to see which would issue the most pronouncements on accounting and reporting within the year? At this time (about six weeks from year-end), 1976 might be considered comparatively dull.

The SEC's 1976 contributions to increasing the workload of registrants' corporate accounting departments and their independent auditors were Accounting Series Release No. 177, Notice of Adoption of Amendments to Form 10-Q and Regulation S-X Regarding Interim Financial Reporting, (issued in late 1975 but effective for various dates in 1976) and ASR No. 190, Notice of Adoption of Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data, (issued in March 1976 and effective for years ending on or after December 25, 1976 for those registrants to which it applies).

During 1976 the FASB devoted the greater part of its resources to the project on Conceptual Framework for Accounting and Reporting and has not actually adopted any Financial Accounting Standards. The Board did issue six interpretations relating to Statements No. 5, 8 and 12 in September. Exposure drafts of proposed Statements on Accounting for Leases (revision of earlier draft) and on Prior Period Adjustments, an exposure draft of a proposed interpretation of APB Opinion No. 28 on Accounting for Income Taxes in Interim Periods and a discussion memorandum on Business Combinations and Purchased Intangibles have also been issued. Other projects for which discussion memoranda were issued in earlier years are Criteria for Determining Materiality, Accounting for Employee Benefit Plans and Accounting for Restructured Debt. The public hearing has been completed on each of these. A draft of the final Standard on Financial Reporting by Segments of a Business Enterprise is reportedly near completion. Projects for which a discussion memorandum is being drafted are Accounting for Interest Costs, Including Interest Capitalized, Accounting and Reporting in the Extractive Industries and Interim Financial Statements. Also, an exposure draft concerning disclosure of payments scheduled for redeemable preferred stock is being prepared.

The Accounting Standards Division of the American Institute of Certified Public Accountants issued two Statements of Position in August 1976. The first was Accounting Practices in the Record and Music Industry and the second was Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry. There are proposed SOPs on Accounting for Employee Stock Ownership Plans, Hospital Accounting (Application of FASB No. 12 to Hospitals and Accounting and Auditing Considerations Regarding Hospitals That Self-Insure against Mal-Practice Claims) and Financial Accounting and Reporting by Investment Companies (Problems Regarding Money-Market Funds, Put and Call Options, Organization Expenses, Amortization of Deferred Costs, Payment of Fees for Research and the Valuation of Short-Term Investments). A report has been prepared for distribution on GAAP for Small Businesses. Other topics under consideration are Revenue Recognition for Future Service Agreements, Required Disclosures in Interim Financial Statements (relates to concerns arising from ASR No. 177), Accounting and Auditing for Construction Costs and Contract Accounting, Accounting Principles for Non-Profit Organizations and Valuation of Real Estate in Cases of Repossession (issuance of an SOP will probably be deferred until the FASB has settled the restructured debt problem).

The AICPA's Auditing Standards Executive Committee issued two Statements on Auditing Standards earlier this year. These were SAS No. 12: Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments and SAS No. 13: Reports on Limited Review of Interim Financial Information. SAS No. 13 relates to reporting on interim financial information in conjunction with the requirements of ASR No. 177. Exposure drafts of several proposed Statements have been issued; namely, Special

Reports, Illegal Acts by Clients, The Independent Auditors' Responsibility for the Detection of Errors or Irregularities and Reports on Comparative Financial Statements. The first three of these are now in the "ballot draft" stage. Some of the other subjects under consideration and in various stages of completion are Preferability of Accounting Principles (an interpretation of APB No. 20), Planning and Supervision, Required Review of Internal Control, Contingencies and Reporting on Uncertainties, Representation Letters, Replacement Cost relates to ASR No. 190), and an Interpretation Relating to Reporting on Pension Funds where the plan is administered by a bank or insurance company.

Limitations of space prohibit analyzing each pronouncement or proposal. It is hoped that mention of the subject matter will suffice as a reminder of the existence of a pronouncement or proposal applicable to a specific area of practice. A few of the pronouncements affecting year-end work will, however, be described to some extent.

ASR No. 177

As indicated by its title, this release encompassed both the amendment of Form 10-Q and the amendment of Regulation S-X. Form 10-Q was expanded to require not only results of operations for the first three quarters of a registrant's fiscal year but also a condensed balance sheet and statement of changes in financial position. Since the revised instructions were effective for quarters beginning after December 25, 1975, the new requirements should now be well-known. The Regulation S-X amendment added Rule 3-16(t) which requires of certain registrants disclosure in a note to the financial statements of net sales, gross profit, income before extraordinary items and cumulative effect of a change in accounting, net income and related per share data for each full quarter within the two most recent fiscal years and any subsequent interim period for which income statements are presented. Although the rule mentions two fiscal years, the effective date of the amendment is such that quarterly data for quarters beginning prior to December 25, 1975 are not required in any event. Only registrants who meet both tests set forth in the rule are required to furnish quarterly data. Technically the data is to be furnished only in filings with the SEC; however, the SEC has made it known that it expects the quarterly data in the notes to financial statements in the registrant's Annual Report to Stockholders. The tests mentioned above represent an amendment adopted in September 1976 of Rule 3-16(t) as originally adopted in 1975. The first test contained several detailed requirements relating to the trading of the registrants's stock and should be read carefully. To meet the second test, the registrant and its consolidated subsidiaries must either have had net income after taxes, but before extraordinary items and cumulative effect of an accounting change, of at least $250,000 for each of the last three fiscal years or had total assets of at least $200 million for the last fiscal year-end.

Also adopted in ASR No. 177 was Rule 2-02(e) which states "if the financial statements covered by the accountant's report designate as 'unaudited' the note required by Rule 3-16(t), it shall be presumed that appropriate professional standards and procedures with respect to the data in the note have been followed by the independent accountant who is associated with the unaudited footnote by virtue of reporting on the financial statements in which it is included." SAS No. 10, Limited Review of Interim Financial Information, sets forth the nature, timing and extent of procedures the independent auditor should apply to interim financial information and SAS No. 13, Reports on a Limited Review of Interim Financial Information, describes when it is necessary for an auditor to refer to the unaudited note in the report on the examination of the registrant's financial statements.

It should also be noted that the SEC issued a Staff Accounting Bulletin (No. 6) containing interpretations of ASR No. 177 with regard to both the Form 10-Q and the unaudited note.

ASR No. 190

Rule 3-17 of Regulations S-X, adopted in ASR No. 190, required current replacement cost information relative to inventories and productive capacity on hand at the end of each fiscal year for which a balance sheet is required and to cost of sales and depreciation, depletion and amortization for the two most recent fiscal years. The information is to be shown in a note to the financial statements or as part of a separate section of the financial statements following the note. The note or the separate section may be designated "unaudited."

When issuing this release, the SEC formed an advisory committee to consider questions submitted by registrants and their independent auditors and to formulate interpretations for implementation of the requirements. Thus far, SAB No. 7,9,10 and 11 have been issued containing these interpretations.

Only a registrant whose consolidated balance sheet at the beginning of the most recently completed fiscal year reflects inventories and property, plant and equipment before deduction for depreciation, depletion and amortization totaling $100 million or more are required to disclose replacement cost information. In addition, the information is not required for registrants whose total inventories and properties do exceed $100 million when this amount is less than 10 per cent of total assets in the same beginning balance sheet. There are also certain exceptions relative to the effective date which are set forth in ASR No. 190.

FASB INTERPRETATIONS

Interpretations of Statement No. 12, Accounting for Certain Marketable Securities, effective for periods ending after October 15, 1976 are:

No. 10 - Provisions of Statement No. 12 are applicable to personal financial statements of individuals prepared in conformity with generally accepted accounting principles.

No. 11 - Changes in market value, if other than temporary, occurring after the balance sheet date are to be considered and the security written down to a new cost basis; the write-down, which cannot exceed the difference between market value at the balance sheet date and cost, is to be accounted for as a realized loss.

No. 12 - Allowances for market decline established prior to the effective date of Statement No. 12 are to be eliminated and the valuation allowance account required by the Statement established.

No. 13 - Contains procedures to be followed and the disclosure required for marketable securities reported in consolidated financial statements which include subsidiaries whose fiscal year-ends are different from that of the parent.

Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, is an interpretation of the second condition specified in Statement No. 5, Accounting for Contingencies, which condition is that the amount of the loss can be reasonably estimated. The interpretation specifies that when the first condition is met and the estimated amount of loss is a range of amounts, the second condition is also met and a loss shall be accrued. If some amount in the range is a better estimate of the loss than any other amount, that amount is accrued or if no one amount is a better estimate of the loss than the any other amount, the minimum amount in the range is accrued. This interpreation is effective for annual and interim periods beginning after October 15, 1976.

Interpretation No. 15, Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company, is an interpretation of Statement No. 8, Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements. The interpretation provides that such costs are to be translated at historical rates and that a stock life insurance company shall make a computation of a foreign subsidiary's reserve deficiency in dollars after translation. An adjustment of the reserve deficiency as computed by the foreign subsidiary may be required. The interpretation is effective for all unamortized policy acquisition costs reported in financial statements for annual and interim periods ending after December 15, 1976.

Legal Developments

Social Security: The Promises, Problems and Possibilities — Part II

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In Part I of this column, it was shown that the present Social Security system is woefully inadequate in several areas — including the areas of funding and purpose.

Since social security is on a pay-as-you-go basis (it is *not* a funded annuity arrangement) and because of the declining birth rate, the increasing life expectancies, and earlier retirement, the fund is practically bankrupt, even though the tax has increased astronomically in the last twenty years. Each year $75 *billion* more is paid out than is collected. At this rate, the $40-billion trust fund from which these deficits have been financed will be nonexistent in 1981,[1] in spite of new tax increases passed by the Ford Administration to offset the deficit. Furthermore, the problem is being compounded by state and local governments pulling out of the system in favor of private plans. Social security is mandatory for all workers except employees of the U.S. federal government, state and local governments, and charitable organizations. The federal government has never participated in social security and hundreds of other governmental units are now rejecting social security. For example, the employees of neither the State of Alaska nor New York City (since March, 1976) are participating in social security.[2] Furthermore, those employees are winding up with greater benefits under their private plans than are those workers who are manditorily covered by social security. For example, if a thirty-five year old worker, making $18,500 per year, were to put the $21 per week social security into a plan offered by the Insurance Company of North America, the fund at age sixty-five would be $122,245, resulting in a pension of $1,002 per month for life, compared with $366 per month for life under social security which costs the same.[3]

The huge difference can be explained, in part, by the welfare function, as opposed to the annuity function, of social

Notes to social security

[1] "Private Retirement Plans Outshining Social Security," *The Seattle Times*, May 3, 1976, p. D-18.

[2] *Ibid.*

[3] *Ibid.*

[4] Warren Weaver, "A Widower Wins Case on Child Care," *Seattle Post Intelligencer*, March 20, 1975, p. A-7.

[5] Public Law 93-647, 93rd Congress, H. R. 17045, January 4, 1975.

[6] Lou Cottin, *The Seattle Times*, August 29, 1976, p. C-3.

[7] *Seattle Post Intelligencer*, April 14, 1975, p. B-3.

[8] Peat, Marwick, Mitchell & Co., *Tax Reform Act of 1976, Tax Considerations for Individuals*, p. 30-31.

[9] See Part I in the last issue of the *Woman CPA*.

[10] Warren Shore, *Social Security: The Fraud In Your Future*, New York: Macmillan Publishing Co., Inc., 1975, pp. 127-139.

security. Since its inception, social security has been geared in favor of lower income workers: they receive much higher returns on their "contributions" than do higher-paid individual workers.

The problem can be simply stated: in fulfilling its welfare function, social security violates its *annuity* function, and the reverse would also be true. When one considers the concepts of human "rights" and "fairness," the problem becomes even more complex. Consider, for example, the effect social security has on women, both workers and housewives.

More Problems, Especially for Women

Through a maze of oversight, intent, and accident, most women are discriminated against under the social security laws. Originally, the system was geared toward the de facto situation of most Americans: the husband worked and earned the living while the wife worked at home. They stayed married, retired together (does a housewife ever "retire"?) and lived on his pension. Accordingly, an added benefit equal to one-half the pension of the male worker was added for his wife. A female worker does not receive a pension of 150 percent if she is married, however, so a married working woman gets less coverage for the same contribution. If a male worker died, his wife received survivor's benefits automatically if she was age sixty or had minor children in the home; a male whose wife died had to prove that more than 50 percent of his support came from his wife in order to collect. This surviving spouse inequity was recently struck down by the Supreme Court,[4] but the retirement inequity is still in the law. Thus, two males with wives would receive the same benefits as three working women who had paid 50 percent more in contributions.

Women in general receive smaller pensions than men because of their lower salaries. The across-the-board pay discrimination against women perpetuates the same discrimination during their retirement years. An additional handicap for women arises when they leave the labor force to raise children — those years of no contributions, in excess of five years, serve to further reduce their already scant pensions.

Working couples sometimes discover that their two pensions total less than if only one had worked, earning the same total income, because benefits are based on individual earnings rather than the combined family earnings. Some working women take a "wife's" pension rather than a worker's pension because the benefits are higher. It is not difficult to imagine how a female worker feels when one check arrives each month in her husband's name rather than a check in her name and a check in his name.

Divorced non-working wives are the hardest hit, especially if they are over forty when they divorce. Unless they remarry or go to work, they will receive nothing at retirement. Recently[5] a provision was added that if the divorced woman had been married twenty years, she would receive benefits on her ex-husband's account. This brings up the interesting possibility of a man who, at age sixty-five, has been married three times, twenty years each to two women and one year to his current wife. His two ex-wives receive pensions and he receives his regular 150 percent pension with his present wife. Who pays for all this? Certainly not the man whose three wives are receiving benefits.

Surprizingly enough, all the popular magazines and newspapers do not focus on the working women's social security problems. They prefer, instead, to write articles like "Wives Deserve Equal Social Security Pay,"[6] with typical "housewives-are-wonderful-don't-they-deserve-more?" logic. No one adds to this argument about "rights" the crucial half of the equation: who is going to pay for it? What people "deserve" or need or want is very compelling, but those "rights" cost a great deal of money. Sylvia Porter[7] reasonably suggests that husbands pay for it. Since social security is mandatory anyway, maybe legislators will decide to make "housewives coverage" mandatory too. In some foreign countries, including Germany and Sweden, a non-working woman can continue paying into social security, provided she has worked as a covered employee at some time during her life.

A partial, but inadequate, solution has been introduced by the *Tax Reform Act of 1976*. A working spouse can set up an Individual Retirement Account (IRA) and contribute an additional, tax deductible, $250 on behalf of the non-working spouse. If the accounts are separate, one-half goes to each; if a joint account is used, each owns one-half the account.[8] Since the usual limit is $1,500 the additional $250 is not as significant as is the fact that the law at least recognizes the problem. One can expect the amount to be raised in future sessions of the Congress.

Another typical housewife's problem arises when the covered husband dies after the children are grown but before the widow reaches sixty years of age. The interim period can easily be twenty years, and the housewife will receive nothing. At age forty or so, the job opportunities for a former housewife are not abundant either. Any woman who ties her economic future to her husband stands to lose everything through divorce or death, neither of which she can control. Should social security take on this insurance function? If so, should it also take on the insuror function when a single working woman loses her job or business? Or what about men who lose jobs at middle age and cannot find a comparable position (not at all uncommon in, say, the aerospace industry)? Exactly where should social security's function end?

The Possibilities

There are several possible courses of action in regard to the rising costs of social security and its inequities.

One possibility is for our elected representatives to continue down the path they have traveled so far. Since benefits are tied to inflation, Congress can continue promising future benefits to be paid out of future non-existent funds. The ultimate outcome will be a day of reckoning in which either the benefits cannot be paid or the tax on workers increases so radically that the taxpayers simply cannot pay it. The catastrophic end result would be the same. Something else must be done.

Another approach would be to separate the annuity function and the welfare function. Workers would then simply purchase an annuity to be used at death, disability or retirement as they see fit, or upon death to be distributed to the qualifying heirs. The welfare function would have to be financed out of general revenues which would increase taxes. In this way, the cost of supporting hardship cases would be clearly stated as a tax, not as the disguised "contribution" it now is. If people would recognize that social security is a tax, a welfare transfer payment, a redistribution of wealth, and *not* a personal funded pension plan, they might very well recognize that demanding more benefits as a matter of "right" will result in a real out-of-pocket expense to them. The system never should have been double-tied[9] to inflation, and it is time people recognize the cost inherent in such a plan.

If taxpayers want to do away with the annuity function and emphasize the welfare function, they must be prepared to receive a small pension if they have been frugal and otherwise provided for their retirement. Richer people would pay into the plan and receive no benefits. It is doubtful that most working middle-class people would accept such a plan. It might result in a national phobia of "live fast, love hard and spend everything because social security will pay only if you are broke."

Another possibility is to ignore the welfare function and compensate with a negative income tax. With the passage of the low-income credit last year this approach may be the one Congress decides upon.

One rather elaborate suggestion[10] is to pair young workers, say, age 20, with retired people on a one-to-one basis. The young worker would pay in for the retired worker until the latter's death, then the young worker could continue paying into an annuity for her-or himself. With an estimated thirty to thirty-five years left to pay in, the young worker would have time to build a nice pension. After two or three generations, all workers would be on an annuity basis, and the whole problem of what to do with the welfare function would presumably disappear.

Another possibility is to determine statistically at what age a straight pension would be more beneficial for workers and drop those under that age from social security coverage and require them to pay an equal amount into a private pension plan of their choice, rather like the existing IRA, for their working lives. They would lose all they've paid in to social security but would have a guaranteed pension, or lump-sum payment, at age sixty-five. The people over this statistically determined age would receive social security benefits under today's schedule. The huge amounts needed to fund the older workers would have to be raised with a massive, very long-term government debt to be paid off out of general revenues over the next one or two hundred years. This prohibitive cost could be met only over the long term. But if it is not done the long term does not hold much future for anybody, including workers and retirees and especially for women.

Small Business

To Incorporate Or Not To Incorporate

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The 1976 Tax Reform Act provides for the continuation of reduction in corporate tax rates and increase in corporate surtax exemption. This brings up the question once again whether it is advisable for the small business to be incorporated or to continue operating as a single proprietorship or a partnership.

Prior to the Tax Reduction Act of 1975, corporate income was subject to 22 percent normal tax on the first $25,000 of net income and to 22 percent normal tax plus 26 percent surtax on net income exceeding $25,000, for a total of 48 percent on income over $25,000.

The Tax Reduction Act of 1975 increased the corporate surtax exemption from $25,000 to $50,000 and reduced the normal tax to 20 percent on the first $25,000 of taxable income. This resulted in a 20 percent rate of tax on the initial $25,000 of taxable income, a 22 percent rate on the next $25,000 of taxable income and a 48 percent rate on taxable income in excess of $50,000. These tax reductions applied for 1975 and were extended for the first six months of 1976 by the Revenue Adjustment Act of 1975.

The 1976 Tax Reform Act extends the 20 percent corporate tax rate on the first $25,000 of taxable income and the $50,000 corporate surtax exemption through December 31, 1977.

Thus, in 1976 and 1977 and possibly in future years, if the reduction is extended again a corporation with yearly taxable income of $50,000 pays federal income tax of $10,500 per year. A married couple with $50,000 of taxable income pays Federal income tax of $17,060 less a personal exemption credit which is, at this income level, the greater of $35 per capita or $180. It must be mentioned that a corporation is not allowed to reduce its income by personal exemptions and itemized or standard deductions, nor is it allowed a personal exemption credit Nevertheless, the difference in tax is sizeable, and it would seem that if an individually owned business nets upward of, say, $35,000 per year, incorportaiton shoould at least be considered.

Other advantages of the corporate form of business are of longer standing than the reduction of the tax rate, but they should also be remembered in the decision making process.

Pension and profit sharing plan legislation has long favored the corporation over the proprietorship or partnership. ERISA has made some changes in favor of the non-corporate business owner, as far as the allowable amounts of contributions to a profit sharing or pension plan are concerned. But the vesting provisions for Keogh Plans are still as harsh as they ever were. Immediate 100 percent vesting is required, while in corporate plans full vesting sometimes does not take palce for fifteen years. This, of course, gives the corporate employee a strong incentive to stay with the employer who has made contributions for him or her, while the employee of an individual proprietor who pays contributions to a Keogh Plan has no such incentive. For individual proprietors with more than one or two employees, Keogh Plans become very expensive without the benefit of retaining valuable employees who want to protect their pension plan investments. These employees can take their fund with them in full one day after it was contributed for their benefit. In addition, they can take advantage of rollover provisions and thereby escape immediate tax consequences.

There are also fringe benefits for corporations which are not available to individual proprietors or partnerships. The cost of group-term life insurance for corporate employees is deductible to the corporation. The employee is not taxed on group-term life insurance coverage up to $50,000 (Section 79, IRS Code).

Under Section 162, a corporate employer can take a business deduction for amounts paid or accrued under an employee medical expense plan or under an employee sickness, accident, or hospitalization plan, and the premiums paid are not taxable income to the employee. In a partnership or proprietorship only the premiums paid for common-law employees are deductible business expenses. Owners or partners can deduct one-half of their health insurance and possibly more on their individual income tax return if they itemize their deductions.

Deferment of tax is sometimes the result of an incorporation in the middle of a calendar year. When a business is being incorporated on, say, October 1, 1976, the tax on the income for the last three months of 1976 is deferred to 1977 except for the tax on the officers' salaries.

Among the non-tax advantages of operating as a corporation, the limited liability of the stockholders comes to mind. However, in a closely held corporation, this advantage is usually all but eliminated by the personal guarantee required of the stockholder by the creditors when corporate loans are negotiated.

We would do the client who is considering incorporation a disservice if we did not point out the disadvantages. First, there is the cost. Legal and accounting services required to make a changeover can cost between $500 and $1,000.

Corporate losses (unless the business is operated as a sub-chapter S corporation), cannot be deducted from the stockholder's other income to arrive at taxable income. These losses are available for carrybacks and carryovers only.

The owner of a business who has been operating as a single proprietor for some time, will often find it difficult to make the transition from individual owner to corporate officer and stockholder. Officers' salaries will have to be determined in meetings with other corporate officials. Records have to be maintained on these meetings. It will no longer be acceptable to dip into the petty cash fund and call it a "draw," or to write a business check for personal expenditures, such as vacations or a down payment on the family car. The corporation is a much more sophisticated form of business than a proprietorship or even a partnership, and the former proprietor turned stockholder often cannot get used to the idea that the person and the corporation are two separate legal entities.

There is also the problem of double taxation. Once a business is incorporated, the assets belong to the corporation, not the stockholder. If an asset is sold at a gain, the corporation pays income tax on the gain. When the money is distributed to the stockholder by way of a dividend, he or she pays income tax on the distribution. When a corporation is liquidated, there is the danger of double taxation even though this can often be minimized or even eliminated by liquidating under Section 333 (one-month liquidation) or Section 337 (twelve-month liquidation). These IRS Code sections contain relief provisions for corporate liquidations.

Considering and weighing the advantages and disadvantages of incorporation for the small business, it may be predicted the successful owner of a business, after seeking the advice of a capable accountant, an equally capable attorney and a conscientious and knowledgeable insurance advisor, may well find that there will be after-tax dollars along the corporate route. But he or she must be aware that running the business "by the seat of one's pants" is OUT and "playing it by the rules of the book" is IN if the corporate form of business is to be successful.