

SPECIALIZED INDUSTRY GAAP



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PREFACE

Specialized Industry GAAP discusses all of the important authoritative pronouncements on GAAP for specialized industries. The GAAP pronouncements include Financial Accounting Standards Board (FASB) statements, interpretations, technical bulletins, and concepts as well as the unsuperceded GAAP of the American Institute of CPAs (AICPA). The GAAP pronouncements include statements of Financial Accounting Standards Board (FASB), referred to as SFAS throughout the course, interpretations, technical bulletins, and statements of financial accounting concepts (SFAC) as well as the unsuperceded GAAP of the American Institute of CPAs (AICPA).

This course discusses all of the important authoritative pronouncements on GAAP for specialized industries. This course addresses accounting principles, financial reporting presentation requirements, required and recommended disclosures for such industries as, banking, cable television, computer software, franchising, insurance, motion picture, record and music, government contracts, oil- and gas-producing, real estate, not-for-profit, finance, and mortgage banking industries.

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CHAPTER 1

BANKING AND THRIFT INDUSTRY

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Explain how to account for the acquisition of a bank and thrift institution.
- Discuss how to account for financial assistance granted by a regulatory agency to an entity that has acquired a bank or thrift institution.
- Determine goodwill and value other assets acquired as a result of business combination
- Account for troubled financial institutions
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TERMINOLOGY

Carrying amount. The face amount of the interest-bearing asset plus (or minus) the unamortized premium (or discount).

Commitment fees. Fees charged for entering into an agreement that obligates the enterprise to make or acquire a loan or to satisfy an obligation of the other party under a specified condition. For purposes of this Statement, the term commitment fees include fees for letters of credit and obligations to purchase a loan or group of loans and pass-through certificates.

General reserve. Used in the context of the special meaning this term has in regulatory pronouncements and in the U.S. Internal Revenue Code.

Incremental direct costs. Costs to originate a loan that (a) result directly from and are essential to the lending transaction and (b) would not have been incurred by the lender had that lending transaction not occurred.

Long-term interest-bearing assets. For purposes of this section, these are interest-bearing assets with a remaining term to maturity of more than one year.

Net-spread method. Under this method, the acquisition of a savings and loan association is viewed as the acquisition of a leveraged whole rather than the acquisition of the separate assets and liabilities of the association.

Origination fees. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. This term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction and also includes syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

Pretax accounting income. Represents income or loss for a period, exclusive or

related income tax expense, determined in conformity with generally accepted accounting principles.

Reserve for bad debts. Term is used in the context of the special meaning this term has in regulatory pronouncements and in the U.S. Internal Revenue Code.

Separate-valuation method. Under this method, each of the identifiable assets and liabilities (assumed) of the acquired savings and loan association is accounted for in the consolidated financial statements at an amount based on fair value at the date of acquisition, either individually or by types of assets and types of liabilities.

Taxable income. Represents pretax accounting income (a) adjusted for reversal of provisions of estimated losses on loans and property acquired in settlement of loans, gains or losses on the sales of such property, and adjusted for permanent differences and (b) after giving effect to the bad debt deduction allowable by the U.S. Internal Revenue Code assuming the applicable tax return were to be prepared based on such adjusted pretax accounting income.

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in the banking and thrift industry are:

- SFAS 72 (*Accounting for Certain Acquisitions of Banking and Thrift Institutions*).
- SFAS 147, *Acquisitions of Certain Financial Institutions*
- APB Opinion No. 23 (*Accounting for Income Taxes—Special Areas*).
- SFAS 91 (*Accounting for Nonrefundable Fees and Cost Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*).
- SFAS 104 (*Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions*).
- SFAS 109 (*Accounting for Income Taxes*).
- SFAS 115 (*Accounting for Certain Investments in Debt and Equity Securities*).
- SFAS 144 (*Accounting for the Impairment or Disposal of Long-Lived Assets*).
- SFAS 147 (*Acquisitions of Certain Financial Institutions*).
- FASB Interpretation No. 9 (Applying APB Opinions 16 and 17 When a Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method).
- FASB Technical Bulletin No. 85-1 (*Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating Preferred Stock*).

Following are the titles issued by the Emerging Issue Task Force (EITF) relating to topics of the banking and thrift industries:

- Issue No. 84 –9 (*Deposit Float of Banks*).
- Issue No. 84 –31 (*Equity Certificates of Deposits*).
- Issue No. 85– 8 (*Amortization of Thrift Intangibles*).
- Issue No. 85– 41 (*Accounting for Savings and Loan Association Under FSLIC Management Consignment Program*).
- Issue No. 85– 42 (*Amortization of Goodwill Resulting from Recording Time Savings Deposits at Fair Values*).
- Issue No. 85– 44 (*Differences between Loan Loss Allowances for GAAP and RAP*).
- Issue No. 86 –31 (*Reporting the Tax Implications of a Pooling of a Bank and a Savings and Loan Association*).
- Issue No. 87–22 (*Prepayment to the Secondary Reserve of the FSLIC*).
- Issue No. 88–19 (*FSLIC—Assisted Acquisitions of Thrift*).
- Issue No. 88–25 (*Ongoing Accounting and Reporting for a Newly Created Liquidating Bank*).
- Issue No. 89–3 (*Balance Sheet Presentation of Savings Accounts in Financial Statement of Credit Unions*).
- Issue No. 89–18 (*Divestitures of Certain Securities to an Unregulated Commonly Controlled Entity under FIRREA*).
- Topic No. D-39 (*Questions Related to the Implementation of SFAS 115*).
- Topic No. D-47 (*Accounting for the Refund of Bank Insurance Fund and Savings Association Insurance Fund Premiums*).
- Topic No. D-57 (*Accounting Issues Relating to the Deposit Insurance Funds Act of 1996*).
- Topic No. D-78 (*Accounting for Supervisory Goodwill Litigation Awards or Settlements*).

RULES, CONCEPTS, AND ILLUSTRATIONS

Previously, under SFAS 72, *Accounting for Certain Acquisitions of Banking and Thrift Institutions*, guidance for acquisitions of banks and thrifts was industry based. GAAP required that these financial institutions recognize any excess of fair value of liabilities assumed over the fair value of tangible and identifiable intangible assets acquired as an unidentifiable intangible asset. In addition, the unidentifiable intangible asset was required to be subsequently amortized. Under the guidance of SFAS 147, *Acquisitions of Certain Financial Institutions*, these requirements are removed (except for such transactions between two or more mutual entities). Acquisitions of financial institutions must now be accounted for in accordance with SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 147 also modifies SFAS 144, *Accounting for the Impairment and Disposal of Long-Lived Assets*, which now requires that its scope be augmented to include financial institution long-term intangible assets such as depositor and borrower-relationship assets and credit cardholder intangible assets. These intangible assets must now be tested using the undiscounted cash flow recoverability test and other impairment measurement requirements for the purpose of recognizing and recording any impairment loss that may have occurred during the period. In addition, SFAS 72 also requires that acquisitions of a branch (i.e., a less-than-whole financial institution) should be accounted for as a business combination if it meets the definition of a business. If it does

not satisfy the definition, it should be accounted for as an acquisition of net assets that does not generate the recognition of goodwill.

The benefit of these changes is that now acquisitions of financial institutions (except for mutual companies—where the old rules still prevail) will be accounted for (as are other business acquisitions) in accordance with SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*. The requirements of SFAS 147 clearly result in an improvement to financial reporting comparability.

According to SFAS 72, in a business combination involving the acquisition of a banking or thrift institution, when the fair value of liabilities assumed exceeds the fair value of identifiable assets acquired, the unidentifiable intangible asset recognized should usually be amortized over a period no greater than the estimated remaining life of the long-term interest-bearing assets acquired. Amortization is at a constant rate applied to the carrying amount of those interest-bearing assets expected to be outstanding at the beginning of each subsequent period. Thus, the amortization period is no longer than that over which the discount on the long-term interest-bearing assets acquired is to be recognized as interest income using the interest method. According to SFAS 142, an entity should evaluate the remaining useful life of an amortizable intangible asset each reporting period. However, SFAS 72 states that the period of amortization of the unidentifiable intangible asset may not exceed 40 years or be revised upward. In other words, low-rate interest-bearing assets may have been discounted to fair value by applying current (higher) interest rates, and the fair value of the liabilities assumed may then exceed the fair value of the assets acquired. In that case, the unidentifiable intangible asset and the discount on the long-term interest-bearing assets acquired will be amortized to income using the interest method over the same period.

KEY GAAP

Acquiring Banking and Thrift Institutions

A full or partial acquisition of a financial institution that constitutes a business combination should be accounted for by the purchase method, as required by SFAS 141, *Business Combinations*. SFAS 141, par. 9, defines a business combination in the following way:

...a business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities. ...provisions apply equally to a business combination in which (a) one or more entities are merged or become subsidiaries, (b) one entity transfers net assets, or its owners transfer their equity interests to another, or (c) all entities transfer net assets or the owners of those entities transfer their equity interests to a newly formed entity (some of which are referred to as roll-up or put-together transactions)...An exchange of a business for a business also is a business combination.

If the acquisition is not a business combination, then the transactions should be recorded (in general) at fair value and should not give rise to goodwill.

Accounting for the Impairment and Disposal of Long-Term Customer Relationships Intangible Assets

The scope of SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, now includes long-term customer-relationship, intangible financial institution related assets that are recognized when a financial institution is acquired. These assets include depositor- and borrower-relationship intangible assets, credit cardholder intangible assets, and servicing assets. These first two assets should not be tested for impairment under SFAS 144. The last, servicing assets, are tested for impairment under SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Savings and Loan Associations' Bad Debts Reserves

Governmental regulatory bodies require that stock and mutual savings and loan associations restrict part of their earnings to general reserves as a means of protecting depositors against the possibility of loss. In addition, the IRS allows these entities to deduct an amount as a reserve for bad debts in determining taxable income. This amount is generally different from the amount that is deducted on the income statement in determining pretax financial income (i.e., under GAAP for financial accounting purposes). Therefore, as would be assumed, taxable income and pretax financial income will differ.

Under GAAP, a savings and loan association is precluded from providing deferred taxes on the difference between taxable income and pretax accounting income attributable to its bad debts reserve that arose in tax years beginning December 31, 1987 (the base-year amount). However, if circumstances indicate that an association is likely to pay income taxes, either currently or in later years (because of known or expected reductions in the bad debts reserve), income taxes attributable to that reduction should be accrued as tax expense for the current period. The income tax expense that is accrued in this manner should not be accounted for as an extraordinary item.

Nonrefundable Fees and Costs Associated with Lending Activities and Loan Purchases

Standards of financial reporting and reporting for nonrefundable fees and costs associated with lending activities and loan purchases are very important to the activities of banking and thrift institutions. Primary guidance in this area is derived from SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. The following salient lending guidance relating to the banking and thrift activities are enumerated below:

1. Loan origination fees should be deferred and recognized over the life of the related loan. It should be recognized in the form of interest income as an adjustment of the loan's yield. Loan origination fees consist of:
 - a. Fees charged to borrowers as prepaid interest or buy-downs that reduce the loan's nominal amount.
 - b. Lender reimbursement for origination activities.
 - c. Fees charged to the borrower that relate directly to making a loan that is approved quickly or that is complex.

- d. Fees that are yield adjustments to rates that would not have otherwise been extended without the fee.
2. Direct loan origination costs are defined as the incremental costs of loan origination with independent third parties for a loan that represent costs directly related to specified activities performed by the lender for that loan. These activities may consist of:
 - a. Evaluating the prospective borrower's financial condition
 - b. Evaluating and recording guarantees, collateral, and other security arrangement
 - c. Negotiating loan terms
 - d. Preparing and processing loan documents and
 - e. Closing the transaction
 1. Direct loan origination fees should be deferred and recognized as a reduction in the yield of the loan. For any given loan, loan origination fees and related direct loan origination costs should be offset and only the net amount should be deferred and amortized. SFAS 91 specifically prohibits the practice of recognizing a portion of loan origination fees in a given period for the express purpose of offsetting all or part of the cost of origination.
 2. Fees received for a commitment to originate or purchase a loan or group of loans should be deferred. If the commitment is exercised, then the fees should be recognized over the life of the loan as an adjustment to yield. If the commitment expires unexercised, the fees should be recognized in income upon expiration of the commitment. If the probability of exercise is remote, then the commitment fee should be recognized as service fee income over the commitment period amortized on a straight-line basis. If exercise does occur, then the remaining unamortized commitment fee should be recognized over the life of the loan as an adjustment to yield. If the commitment fee is determined retrospectively as a percentage of the unused line credit that is available, and if the percentage rate of the fee is nominal in relationship to the stated rate of interest on the borrowing, and the loan is made at the market rate of interest at the date the loan is made, then the commitment fee should be recognized as service fee income.
 3. If a loan or group of loans is purchased, the initial investment generally includes the amount paid to seller as well as any fees that were paid or less any fees that were received. Therefore, the initial investment will differ from the related loan's principal amount when the purchase was made. The discrepancy should be accounted for as an adjustment of yield over the life of the loan. Any other costs incurred in either acquiring the loan or committing to it should be charged to expense in the period incurred.

4. In general, any amounts that are required to be recognized as yield adjustments over the life of the related loan (e.g., net fees, costs, etc.) should be computed using the interest method based on its contractual terms of the loan. The use of the effective interest method is used to insure that interest income (and recognition of related fees and costs) is recognized in a manner that produces a constant effective yield on the net investment in the receivable.
5. Investments in financial instruments that may be prepaid or settled in a way that would preclude the investor from not recovering all of its recorded investment (e.g., loans, receivables, retained interests in securitizations, interest-only strips, etc.) should be accounted for as available-for-sale debt securities.
6. Financial Statement Disclosure—Any unamortized amounts of loan origination, commitment, and other costs and fees that are being recognized as an adjustment of yield should be recorded on the balance sheet as a part of the loan to which it relates. The portion of these amounts that has been recognized as an adjustment to yield should be reported as part of interest income. Commitment fees (or other fees) that are being amortized over the commitment period on a straight-line basis or included in income when the commitment expires, should be shown as service fee income.

Specialized Disclosure Requirements—Cash Flows Statement

SFAS 104, *Statement of Cash Flows-Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows From Hedging Transactions*, amends SFAS 95, *Statement of Cash Flows*, regarding the specialized disclosure requirements relating to the Cash Flows Statement of banking and thrift associations.

Specialized Disclosure Requirements

Banks, savings institutions, and credit unions are not required to report the gross amounts of cash receipts and cash payments for the following:

1. Deposits placed with other financial institutions and withdrawals of deposits.
2. Loans made to customers and principal collections of loans.
3. Time deposits accepted and repayments of deposits.

When a banking or thrift association is part of a consolidated entity, net amounts of cash receipts and cash payments for deposit and lending activities of these entities should be reported separately from the gross amounts of cash receipts and payments for the other investing and financing activities of the consolidated entity. This guidance also applies to parts of a consolidated entity such as a subsidiary of a bank, savings institution, or credit union that is not a bank, savings institution, credit union or the like.

CHAPTER 2 BROADCASTING INDUSTRY

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Outline accounting for program license agreements, including cost allocation, amortization and capitalization
- Discuss network affiliation agreements
- Account for barter transactions

TERMINOLOGY

Barter. The exchange of unsold advertising time for products or services. The broadcaster benefits (providing the exchange does not interfere with its cash sales) by exchanging otherwise unsold time for such things as programs, fixed assets, merchandise, other media advertising privileges, travel and hotel arrangements, entertainment, and other services or products.

Broadcaster. An enterprise or an affiliated group of enterprises that transmits radio or television program material.

Daypart. An aggregation of programs broadcast during a particular time of day (for example, daytime, evening, late night) or programs of a similar type (for example, sports, news, children's shows). Broadcasters generally sell access to viewing audiences to advertisers on a daypart basis.

License agreement for program material. A typical license agreement for program material (for example, features, specials, series, or cartoons) covers several programs (a package) and grants a television station, group of stations, network, pay television, or cable television system (licensee) the right to broadcast either a specified number or an unlimited number of showings over a maximum period of time (license period) for a specified fee. Ordinarily, the fee is paid in installments over a period generally shorter than the license period. The agreement usually contains a separate license for each program in the package. The license expires at the earlier of the last allowed telecast or the end of the license period. The licensee pays the required fee whether or not the rights are exercised. If the licensee does not exercise the contractual rights, the rights revert to the licensor with no refund to the licensee. The license period is not intended to provide continued use of the program material throughout that period but rather to define a reasonable period of time within which the licensee can exercise the limited rights to use the program material.

Network affiliation agreement. A broadcaster may be affiliated with a network under a network affiliation agreement. Under the agreement the station receives compensation

for the network programming that it carries based on a formula designed to compensate the station for advertising sold on a network basis and included in network programming. Program costs, a major expense of television stations, are generally lower for a network affiliate than for an independent station because an affiliate does not incur program costs for network programs.

RULES, CONCEPTS, AND ILLUSTRATIONS

SOURCES OF GAAP

The key source of authoritative GAAP relating to guidance in the broadcasting industry is:

- SFAS 63 (*Financial Reporting by Broadcasters*).
- SFAS 139 (*Recission of SFAS 53 and Amendment SFAS 63, 89, and 121*).

RULES, CONCEPTS, AND ILLUSTRATIONS

A license agreement for program material generally includes specials, features, series, or cartoons. The agreement covers a package consisting of several programs granting a television station (or group), network, pay television, or cable television (licensee) the right to broadcast either an unlimited or specified number of showings over a license period (specified by parties) for a given fee. The agreement usually consists of separate licenses for each program in the package. The licensee must pay the required fee for the program materials even though the rights may not be used. If the rights of use are not exercised, they revert to the licensor with no refund to the licensee. The license period specified in the license agreement defines a reasonable period of time within which the licensee can exercise its purchased rights for programming use. It does not delineate the period of time in which a licensee may use programming material on a continuing basis.

A broadcaster's acquisition of a license agreement to broadcast program material should be accounted for as a group of rights or privileges. The rights that have been acquired and the related obligation incurred should be reported by the licensee as an asset and liability. They may be shown at either the gross amount or the present value of the liability when the license period begins and certain other conditions are satisfied. Broadcasters may also participate in barter transactions. That is, they exchange unsold advertising time for programs, fixed assets, merchandise, travel and hotel arrangements, entertainment and other products, or services. These events generally should be accounted for as nonmonetary transactions and therefore their recognition and disclosure must adhere to the guidance of Accounting Principles Board (APB) Opinion No. 29, *Accounting for Nonmonetary Transactions*. A network affiliation agreement should be accounted for as an intangible asset. If a broadcaster owns the program material that it will show on its network, cable, or television station, it must follow guidance of AICPA Statement of Position (SOP) No. 00-2 (see Motion Picture Industry).

KEY GAAP

Program License Agreements

SFAS 63 requires that a broadcaster's acquisition of a license agreement for program

material should be reported as an asset purchased and liability incurred when the license period commences and all of the following conditions have been satisfied:

- The program material has been accepted by the licensee in accordance with the conditions of the license agreement.
- The cost of each program constituting the program package is known or is reasonably determinable.
- The program is available for its first showing or telecast. This condition is not met when a conflicting license prevents program broadcasting. However, any restriction under this license or another license with the same licensor regarding programming should not be construed as causing this condition to fail.

Any program license agreement that has been executed but has not met the aforementioned three criteria and was not reported as an asset and liability should be fully disclosed in the notes to the financial statements.

GAAP requires that the license program agreement be classified as a current and noncurrent asset based on its estimated future usage. The related liability should also be dichotomously classified as current or noncurrent based on the future payment terms.

The amount of the recorded asset and liability that is to be reported by the licensee for a broadcast license agreement should be shown at either (1) the gross amount of the liability or (2) the present value of the liability (computed in accordance with APB Opinion No. 21 (APB 21), *Interest on Receivables and Payables*). If the latter option is chosen, the difference between the gross and net liability shall be accounted for as interest (in accordance with APB 21). The present value approach is used in a more limited way than the gross method because APB 21 may be used to impute interest only when the liability exceeds one year and bears an unreasonable amount of interest or none at all. If the debt instrument that is generated in the broadcast license acquisition reflects a reasonable amount of interest, the present value of the debt would be equal to its gross amount and the gross presentation would be appropriate.

Cost Allocation and Amortization of Capitalized Program License Agreement

The total capitalized cost of the program license agreement should be proportionally allocated to the individual programs that compose it based on the relative value of each program to the broadcaster. These amounts are commonly specified in the program license agreement contract. Amortization of the allocated cost should then be based on the estimated number of future showings of each program. If a particular program license provides for an unlimited number of showings, as is usually the case for cartoons and related types of programming, the amortization of the costs should take place over the period of the license agreement because the number of showings cannot be determined.

License agreements for feature programs should be amortized on a program-by-program basis. Program series and other syndicated products should be amortized as a series. Because television series license agreements commonly provide for

rerun rights, the licensee must also ascertain whether the first showing of the series is more valuable to the station than its reruns. If so, the amortization should be based on an accelerated method. If all showings are considered equally valuable, the straight-line method may be used.

Balance Sheet Valuation of Capitalized Program License Agreement

The capitalized program license agreement should be reported on the balance sheet of the licensee at the lower of amortized cost or estimated net realizable value. Each component of the license agreement (programs, series, packages, dayparts [collection of programs broadcast during a particular time of the day, such as daytime, evening, and late night]) should be valued separately. If the licensee's management decides that the usefulness of a program, series, package, or daypart is to be revised downward, amortized cost may have to be written down to a lower estimated realizable value. This lower amount then becomes the new cost basis of the capitalized program license agreement. Once written down to a new cost basis, the asset cannot later be written up for a recovery in value.

Network Affiliation Agreements

A broadcaster may be affiliated with a network under a network affiliation agreement. If a station has signed such an agreement, it receives compensation for the network programming that it carries based on a pre-agreed formula. This formula is designed to compensate the station for advertising sold on a network basis that is included in network programming. Program costs for stations that have network affiliation agreements are generally lower than those for an independent station because the affiliate does not have to incur costs for network programs. These programs generally represent a major expense for television stations.

Network affiliation agreements should be classified as intangible assets. If a network affiliation agreement is terminated and is not immediately replaced or under agreement to be replaced, any remaining unamortized capitalized cost should be charged to expense. However, if there is immediate replacement or there is an agreement for such a replacement, a loss should be recognized equal to the excess of the unamortized cost of the terminated affiliation agreement over the fair value of the new affiliation agreement that replaced it. If, on the other hand, the fair value of the replacement agreement exceeds the unamortized cost of the terminated affiliation agreement, no gain should be recognized in the accounting record or disclosed in the financial statements.

Barter Transactions

Broadcasters commonly exchange unsold advertising time for products or services. That is, they frequently engage in barter transactions in which no material amounts of cash exchange hands between the parties involved. All barter transactions (with the exception of trading advertising time for network programming) should be accounted for at the estimated fair value of the products or services received or advertising time given up, whichever is more clearly determinable. The accounting parameters that must be followed in these transactions may be found in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*. Barter revenue should be recognized when commercials are broadcast, and merchandise or services received should be reported when received or used. Thus, if

advertising time is broadcast before the products or services are compensatorily received, a receivable should be recorded at the same time that the advertising revenue is reported. Correspondingly, if merchandise or services are received prior to the broadcast of an advertising commercial, a liability should be recorded.

CHAPTER 3 CABLE TELEVISION

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Establish the prematurity period and account for its costs.
- Capitalize interest costs during the prematurity period.
- Outline how to recognize hookup revenue and amortize capitalized costs.
- Discuss recoverability of capitalized costs.

TERMINOLOGY

Cable television plant. The cable television plant required to render service to the subscriber includes the following equipment:

*Head-end--*This includes the equipment used to receive signals of distant television or radio stations, whether directly from the transmitter or from a microwave relay system. It also includes the studio facilities required for operator-originated programming, if any.

*Cable--*This consists of cable and amplifiers (which maintain the quality of the signal) covering the subscriber area, either on utility poles or underground. *Drops--*These consist of the hardware that provides access to the main cable, the short length of cable that brings the signal from the main cable to the subscriber's television set, and other associated hardware, which may include a trap to block particular channels.

*Converters and descramblers--*These devices are attached to the subscriber's television sets when more than 12 channels are provided or when special services are provided, such as "pay cable" or two-way communication.

Direct selling costs. Direct selling costs include commissions, the portion of a salesperson's compensation other than commissions for obtaining new subscribers, local advertising targeted for acquisition of new subscribers, and costs of processing documents related to new subscribers acquired. Direct selling costs do not include supervisory and administrative expenses or indirect expenses, such as rent and costs of facilities.

Subscriber-related costs. These are costs incurred to obtain and retain subscribers to the cable television system and include costs of billing and collection, bad debts, and mailings; repairs and maintenance of taps and connections; franchise fees related to revenues or number of subscribers; general and administrative system costs, such as salary of the system manager and office rent; programming costs for additional channels used in the marketing effort or costs related to revenues from, or number of subscribers to, per channel or per program service; and direct selling costs.

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in the cable television industry are:

- SFAS 51 (*Financial Reporting by Cable Television Companies*).
- SFAS 131 (*Disclosures about Segments of an Enterprise and Related Information*).
- SFAS 142 (*Goodwill and Other Intangible Assets*).
- SFAS 144 (*Accounting for the Impairment or Disposal of Long-Lived Assets*).
- Additional Guidance: Related FASB Staff Positions or questions and answers previously issued as FASB Staff Implementation Guides.

RULES, CONCEPTS, AND ILLUSTRATIONS

SFAS 51 presents the standards of financial reporting and disclosure for certain revenues and expenses related to cable television systems. The emphasis of this statement is on special accounting rules applicable to the prematurity period. During this period, a cablevision television system is partly in use and partly under construction. The prematurity period generally begins with the first earned subscriber revenue and ends when the first major construction period has been completed or the achievement of a specified predetermined subscriber level has been reached. Prematurity status is very common in this industry. For example, over time it is usual for cable companies to expand throughout the geographical area that they have franchised. For large and medium-size entities, this effort results in many parts of their system being “energized” while construction progresses in others. Thus, except for the smallest systems, programming is delivered to parts of the area being serviced (with revenues being earned) before construction of the entire system is complete. Thus, virtually every medium-size and large franchise cable television system experiences a prematurity period during which it receives some revenue while continuing to incur substantial costs related to its completion. During the prematurity period, costs incurred that relate to both current and future operations shall be partially capitalized and partially expensed.

KEY GAAP

Establishment of the Prematurity Period

Before revenue is earned from the first subscriber, the management of a cable television entity should establish the beginning and end of the prematurity period. By definition, the prematurity period begins with the first earned subscriber revenue. Its end will vary with the circumstances of the system but will be determined based on plans for completion of the system’s first major construction period. The end of the prematurity period can also be based on the achievement of a specified predetermined subscriber level at which no additional investment will be required for other than cable television plants. Under GAAP, the prematurity period is not to exceed two years. A longer period is justified only in major urban markets. After its establishment, a premature period should not be changed except under highly unusual circumstances. The part of the cable television system that is in the prematurity period should be accounted for separately from the rest of the system and should be clearly distinguished from it. The portion that is in the prematurity period should have most of the following characteristics:

- It should be in a geographically different area or different franchise area.
- It should have mechanical differences, such as different equipment and facilities. For example, it might have separate equipment used to receive the signals of distant television or radio stations whether directly from a transmitter or from a microwave relay system. Equipment used to receive television and radio signals, called head end, may also include separate studio facilities required for operator originated programming if such activities take place in this portion of the cable television system.
- There should be timing differences. For example, its construction or marketing should start at dates significantly different from the other portions of the system.
- There should be investment decision differences. The portion of the cable television system that is in the prematurity period should have different breakeven and return-on-investment analyses or different construction start approvals.
- It should have separate accounting records, separate budgets and forecasts, or other accountability differences.

Accounting for Costs During the Prematurity Period

In general, costs incurred by the system should be charged to the portion of the cable television system in the prematurity period only if they are specifically identified with the operations of that portion. Separate projections for the portion shall be developed, and the portion's capitalized costs should be evaluated separately during the prematurity period for recoverability. Other guidance related to accounting in the prematurity period includes the following:

- Subscriber-related costs and general and administrative expenses shall be expensed as period costs. Subscriber-related costs are those costs incurred to obtaining and retaining subscribers to the cable television system. They include:
 - Cost of billing and collection.
 - Bad debts.
 - Mailings.
 - Repairs and maintenance of subscriber connections.
 - Franchise fees related to revenue or the number of subscribers.
 - Salary of the system manager and office rent.
 - Programming cost for additional channels used in the marketing effort or costs related to revenues from, or the number of subscribers to, channels or program services.
 - Direct selling costs.
- Costs of the cable television plant should be capitalized in full. These include materials, direct labor, and construction overhead.
- Programming and other systems costs that are incurred in anticipation of servicing a fully operating system should be allocated between current and future operations. These costs do not change based on the number of

subscribers. They include such items as property taxes based on valuation of the cable entity as a fully operating system; pole, underground duct, antenna site, and microwave rental based on rental costs for a fully operating system; and local origination programming to satisfy franchise requirements.

The proportion attributable to current operations shall be expensed currently, and the remainder of the expenditures should be capitalized. The amount that should be expensed in the current period is derived by multiplying the total expenditures for the month by the following fraction:

$$\frac{\text{The greatest of a, b, or c}}{\text{Total numbers of subscribers expected at end of prematurity period}}$$

where:

- a = the average number of subscribers expected that month as estimated at the beginning of the prematurity period
- b = the average number of subscribers that would be attained using at least equal (straight-line) monthly progress in adding new subscribers towards the estimate of subscribers that would be attained at the end of the prematurity period
- c = the average number of actual subscribers

The preceding fraction should be determined each month of the prematurity period.

In addition, depreciation and amortization expense should be determined by multiplying the monthly depreciation and amortization based on total capitalized costs expected on completion of the prematurity period by the aforementioned fraction using the depreciation that will be applied by the entity after the prematurity period.

Capitalization of Interest Costs During the Prematurity Period

The interest costs that should be capitalized during the prematurity period should be done in accordance with SFAS 34, *Capitalization of Interest Costs*. SFAS 34 requires that interest costs to be capitalized be determined by multiplying an interest capitalization rate to the average amount of qualifying assets for the system during the period. During the prematurity period, a portion of the system is in use in the earnings activity of the enterprise and therefore is not eligible for interest capitalization. In addition, interest should not be capitalized on phases of the project that are complete and ready for service. In total, the amount of interest cost that is capitalized should not exceed the total amount of interest cost incurred by the total cablevision system for the period.

Recognition of Hookup Revenue and Amortization of Capitalized Costs

Hookup revenue should be recognized as revenue to the extent of the direct selling costs incurred. Direct selling costs include:

1. Commissions.
2. The portion of a salesperson's compensation other than commissions for obtaining

- new subscribers.
3. Local advertising targeted for acquisition of new subscribers.
 4. Costs of processing documents related to new subscribers acquired.

Direct selling costs do not include supervisory and administrative expenses or indirect expenses such as rent and costs of facilities. Subscriber installation costs, including material, labor, and overhead costs, should be capitalized and depreciated over a period no longer than the depreciation period used for the cable television plant. Costs of subsequently disconnecting and reconnecting should be charged to expense of the current period.

The cost of a successful franchise application should be capitalized and subsequently amortized in accordance with SFAS 142, *Goodwill and Other Intangible Assets*. Unsuccessful franchise applications and abandoned franchises should be expensed given their lack of future benefits.

Franchise Applications

Costs incurred in pursuance of successful franchise applications should be capitalized and amortized in accordance with SFAS 142, *Goodwill and Other Intangible Assets*. If a franchise application is deemed unsuccessful or a decision is made to abandon the franchise altogether, its costs should be charged to expense.

Recoverability of Capitalized Assets

The carrying amounts of the capitalized assets and identifiable intangible assets are subject to the requirement of SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Even if it is determined that the entity's capitalized costs are unrecoverable, capitalization of costs should not cease. Instead, the provision required to reduce capitalized costs to their recoverable value should also be increased.

CHAPTER 4

COLLEGES AND UNIVERSITIES

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Discuss the auditing of and reporting on the financial statements of governmental institutions of higher education including colleges, universities, and community or junior colleges.
- State how to recognize depreciation by not-for-profit organizations/

OVERVIEW AND ISSUES

The purpose of *Audits of Colleges and Universities* is to assist in the auditing of and reporting on the financial statements of governmental institutions of higher education including colleges, universities, and community or junior colleges. Even though it does not apply, auditors of elementary, or secondary, schools or school systems may find the guide useful. Nongovernmental organizations should use the AICPA Audit and Accounting Guide, *Not-for-profit Organizations*. Since educational organizations emphasize service, the determination of net income is not the primary focus. Accounting and reporting should be structured so that the emphasis is on the accounting for resources received and used.

Both documents contain illustrations of the form and content of college and university financial statements, including a summary of significant accounting policies and notes to the financial statements. In addition, the SOP contains a chart of accounts.

SFAS 93, *Recognition of Depreciation by Not-for-Profit Organizations*, requires all nonprofit organizations, including colleges and universities to recognize depreciation in the financial statements and to disclose the depreciation expense, the balances of major classes of depreciable assets and the accumulated depreciation at the balance sheet date, and a description of the depreciation method used.

SFAS 116, *Accounting for Contributions Received and Contributions Made*, establishes standards of accounting and reporting for contributions. It applies to all organizations that receive or make contributions. SFAS 117, *Financial Statements of Not-for-Profit Organizations*, addresses not-for-profit organizations, establishes standards for their general-purpose external statements and designates the statement of financial position, the statement of activities, the statement of cash flows and the accompanying notes as a complete set of financial statements. Inconsistent provisions in the SOPs or AICPA Guides are no longer acceptable specialized accounting and reporting.

SOURCES OF GAAP

- SFAS 93, *Recognition of Depreciation by Not-for-Profit Organizations*.
- SFAS 116, *Accounting for Contributions Received and Contributions Made*.
- SFAS 117, *Financial Statements of Not-for-Profit Organizations*.
- SFAS 124, *Accounting for Certain Investments Held by Not-for-Profit*

Organizations.

- SFAC 4, *Objectives of Financial Reporting by Nonbusiness Organizations.*
- SFAC 6, *Elements of Financial Statements.*

TERMINOLOGY

Restricted Current Funds. The funds which may be used for operations, but can only be used for the specific purpose designated by a donor or other external agency.

Unrestricted Current Funds. The funds of educational organizations that may be used for any operational purpose and have not been restricted or designated for any other purpose.

RULES, CONCEPTS, AND ILLUSTRATIONS

Financial Statements

Colleges and universities present the following financial statements:

1. Balance sheet
2. Statement of changes in fund balances
3. Statement of current funds revenues, expenditures, and other changes

The statements should be prepared on an accrual basis.

SFAS 116 requires that contributions received by not-for-profit organizations be reported as restricted support or unrestricted support. Contributions with donor-imposed restrictions are reported as restricted support. Restricted support increases permanently restricted net assets or temporarily restricted net assets. Contributions without donor-imposed restrictions are reported as unrestricted support, which increases unrestricted net assets. Note that if an entity has an accounting policy to imply a time restriction on gifts of long-lived assets, then the gift must be reported as temporarily restricted support, even if the gift has no donor restrictions.

SFAS 117 requires the Statement of Financial Position to show total assets, total liabilities and net assets. Net assets must be categorized as to (1) unrestricted, (2) temporarily restricted, or (3) permanently restricted. The same categories above are used in the Statement of Activities to show the changes in net assets. The Statement of Cash Flow should report the change in cash and cash equivalents.

Not-for-profit organizations must present in the financials all information required by GAAP (unless specifically exempted) and all information required by specialized principles. This information includes display and disclosure provisions of:

1. Financial instruments
2. Loss contingencies

3. Extraordinary, unusual and infrequent events
4. Accounting changes

Aggregation and order of presentation should, generally, be similar to those of a business enterprise.

In the Statement of Cash Flow, the Statement of Activities takes the place of the Income Statement in a business enterprise and change in net assets takes the place of net income. Restricted resources that are used for long-term purposes because of donor stipulation are classified as financing activities.

In the year of application, SFAS 117 does not need to be applied to interim periods. If reported with annual statements, however, interim periods should be reclassified for that year. In the initial year, disclosure is required, for each year presented, of (1) the nature of any restatements and (2) their effect on the change in net assets.

Restatement to reflect retroactive application is necessary if comparative financials are presented for earlier periods.

Contributions

SFAS 116 specifies that unconditional promises to give and contributions received (made) are recognized at fair value in the period received (made). When conditions are substantially met, conditional promises to give are recognized.

Not-for-profits are required to differentiate increases in net assets from contributions between (1) permanently restricted, (2) temporarily restricted, and (3) unrestricted. In the period of expiration, recognition of the expiration of donor-imposed restrictions on contributions must be given. Service contributions should not be recognized *unless* (1) nonfinancial assets are created or enhanced or (2) qualified individuals provide specialized skills that would otherwise need to be purchased. Collections held for public exhibition, education or research in furtherance of public service and comprised of works of art, historical treasures, etc., are not required to be capitalized and recognized as revenue.

In the year of change, retroactive application or recognition of a cumulative effect may be used. Recognition of restriction expirations may be prospectively applied.

Fund Accounting

Colleges and universities use fund accounting to comply with the requirements imposed by the organization's governing board, by donors, and by external entities. Funds consist of a self-balancing group of accounts composed of assets, liabilities, and fund balances (net assets). The following fund groups are often used for colleges and universities:

1. Current funds
2. Endowment and similar funds
3. Loan funds
4. Annuity and life income funds

5. Plant funds
6. Agency funds

The audit guide explains the accounting principles and reporting practices for each of the above fund groups. Internally designated and externally restricted funds must be appropriately indicated and disclosed in the financial statements.

Current Funds Revenues

Revenues are identified by source. Revenues represent the increase in resources to accomplish the objectives of the respective fund.

Restricted current funds received, but not spent, and externally restricted resources to other than current funds are excluded from these revenues.

Current funds revenues (restricted and unrestricted) should be grouped by source of funds as follows:

1. Tuition and Fees
2. Federal Appropriations
3. State Appropriations
4. Local Appropriations
5. Federal Grants and Contracts
6. State Grants and Contracts
7. Local Grants and Contracts
8. Private Gifts, Grants, and Contracts
9. Endowment Income
10. Sales and Services of Educational Activities
11. Sales and Services of Auxiliary Enterprises
12. Sales and Services of Hospitals
13. Other Sources, including expired term endowments and expired life income agreements, if not material; otherwise a separate category
14. Independent Operations

Current Funds Expenditures and Transfers

Expenditures are identified by function. Expenditures represent the using up of resources to accomplish the objectives of the respective fund.

SOP 74-8 defines current funds expenditures as amounts paid to operate the institution. Capital assets, such as equipment and library books are included if operating department's budget for and use current funds to acquire those assets.

SOP 74-8 defines transfers as amounts moved between fund groups. Mandatory and nonmandatory are two types of transfers. Mandatory transfers include transfers from current funds to other groups because of such things as legal or grant agreements. Nonmandatory transfers include transfers because of such things as internal board designations and retransfers back to current funds.

Expenditures and transfers should be grouped by function as follows:

- a. Educational and General Expenditures
 - Instruction
 - Research
 - Public Service
 - Academic Support
 - Student Services
 - Institutional Support
 - Operation and Maintenance of Plant
 - Scholarships and Fellowships
 - Mandatory Transfers
 - Nonmandatory Transfers
- b. Auxiliary Enterprises
 - Expenditures
 - Mandatory Transfers
 - Nonmandatory Transfers
- c. Hospitals
 - Expenditures
 - Mandatory Transfers
 - Nonmandatory Transfers
- d. Independent Operations
 - Expenditures
 - Mandatory Transfers
 - Non mandatory Transfers

STATEMENTS OF POSITION

- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*

This Statement of Position (SOP) provides guidance on the applicability of various sources of GAAP to not-for-profit organizations. The SOP's appendices provide a detailed discussion of the specific sources affected and should be consulted for further analysis. The appendices are categorized by (in respect to not-for-profit organizations):

- (B) Pronouncements that are specifically exempt
- (C) Pronouncements which do not apply due to subject matter
- (D) Pronouncements subject to additional criteria from other sources
- (E) Pronouncements' application of specialized industry practices
- (F) Pronouncements in effect excluding items listed in Appendices (B-E)
- (G) Cross-reference of all pronouncements
- (H) Hierarchy of GAAP

■ SOP 94-3, *Reporting of Related Entities by Not-For-Profit Organizations*

This SOP makes guidance uniform in regard to not-for-profit (NFP) reporting of investments in for-profit (EP) entities and in regard to financial interrelationships with other NEPs. It does not apply to entities covered by the *Audits of Providers of Health Care Services* Audit Guide.

If APB 51, as amended by SFAS 94, applies, a NFP with a controlling financial interest through ownership of a majority voting interest should consolidate FP entities. The nature of the FP's activities will govern the manner of its presentation in the NFP's financials. If APB 18 applies, a NFP should use the equity method to report FP investments. An exception to the use of the equity method is made for NFPs reporting investments at market value in conformity with AICPA audit guides.

If SFAS 94 paragraph 13 applies (temporary control or lack of control by majority ownership), consolidation is prohibited. Otherwise, a NFP should consolidate another NFP if:

1. It has a controlling financial interest through ownership of a majority interest.
2. It has both control (through majority ownership or majority voting on the board) and an economic interest.

Economic interest is present when:

- a. Other entities solicit funds on behalf of the reporting organization (R/O).
- b. A R/O transfers significant resources to another entity to be maintained for benefit of R/O.
- c. A R/O delegates some significant functions to another entity.
- d. A R/O gives or is committed to give funds to the other entity or guarantees material debt of the other entity.

Any restrictions imposed by outside entities regarding distributions and any resulting unavailability of net assets of the controlled NEP should be disclosed if consolidated statements are presented.

A NFP may consolidate another NFP, but is not required to if:

1. It currently consolidates under SOP 78-10 (even if prohibited under SOP 94-3)
2. It has control (other than by majority ownership or majority voting on the board) and an economic interest.

If consolidation is not selected in the previous case, the following disclosures are required:

1. Entity identification and the nature of the relationship that results in control

(such as contract or oversight)

2. Summarized financial data of the controlled NEP
 - a. Total assets, liabilities, net assets, revenues and expenses
 - b. Resources held for or controlled by the reporting entity
 - c. SFAS 57 disclosures

The existence of control or economic interest, but not both, precludes consolidation but requires SFAS 57 disclosures.

This SOP will be reconsidered when the FASB completes its consolidation project.

CHAPTER 5

DEVELOPMENT OF COMPUTER SOFTWARE TO BE SOLD, LEASED, OR OTHERWISE MARKETING

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- State how to account for research and development costs relating to software development.
- Capitalize computer software subsequent to the establishment of technological feasibility.
- Describe purchasing computer software with no alternative future uses.
- Discuss amortization of software costs.
- Explain duplication of costs charged to inventory.
- Outline end-of-period inventory and disclosures on the financial statements.

TERMINOLOGY

Coding. Generating detailed instructions in a computer language to carry out the requirements described in the detail program design. The coding of a computer software product may begin prior to, concurrent with, or subsequent to the completion of the detail program design.

Customer support. Services performed by an enterprise to assist customers in their use of software products. Those services include any installation assistance, training classes, telephone question and answer services, newsletters, on-site visits, and software or data modifications.

Detail program design. The detail design of a computer software product that takes product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.

Maintenance. Activities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions.

Product design. A logical representation of all product functions in sufficient detail to serve as product specifications.

Product enhancement. Improvements to an existing product that are intended to extend the life or improve significantly the marketability of the original product. Enhancements normally require a product design and may require a redesign of all or part of the existing product.

Product masters. A completed version, ready for copying, of the computer software

product, the documentation, and the training materials that are to be sold, leased, or otherwise marketed.

Testing. Performing the steps necessary to determine whether the coded computer software product meets function, feature, and technical performance requirements set forth in the product design.

Working model. An operative version of the computer software product that is completed in the same software language as the product to be ultimately marketed, performs all the major functions planned for the product, and is ready for initial customer testing (usually identified as *beta testing*).

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in computer software to be sold, leased, or otherwise marketed are:

- SFAS 2 (*Accounting for Research and Development Costs*).
- SFAS 86 (*Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*).

RULES, CONCEPTS, AND ILLUSTRATIONS

SFAS 86 is the key source of guidance in the area of accounting for the costs of computer software to be sold, leased, or otherwise marketed. The guidance of this statement relates to software that has been internally created or purchased that is to be externally marketed.

GAAP requires that costs that have been incurred in the development of a computer software product be expensed when incurred to research and development costs until technological feasibility for the product has been established. Technological feasibility is deemed established when a detailed program design or working model for the product is completed. All software production costs incurred after that point should be capitalized and amortized to current and future periods. In computing amortization expense, companies are required to use the greater of the ratio of current revenues to current and anticipated revenues or the amount derived through straight-line amortization computed over the remaining estimated economic life of the computer product. With respect to financial statement disclosure, computer software costs should be reported in the financial statements at the lower of amortized cost or net realizable value.

KEY GAAP

SFAS 86 discusses the accounting for the costs of computer software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process. It applies to computer software developed internally and to purchased software. It does not address the accounting and reporting of cost incurred for computer software created for the internal use of an entity or for the development of software for others under a contractual arrangement.

A software product has the following characteristics:

- It is complete and has exchange value.

- It consists of a collection of programs (e.g., a series of instructions or statements enabling the computer to perform its function) that interact.

Embedded software (or firmware) should be accounted for as described in this section. This type of software is sold as part of a product; for example, there may be software embedded in a personal digital assistant (PDA). Other instances, such as when time-sharing services are provided, also would fall under the scope of this section, as it would not be possible to provide these services without the software.

Research and Development Costs

All costs incurred in establishing the technological feasibility of a computer software product to be sold, leased, or otherwise marketed should be charged to research and development expense when incurred. A computer software product's technological feasibility is established when the developing entity has performed all planning, designing, coding, and test activities that are required to meet its design specifications. Such specifications generally include the product's technical performance, functions, and features. Coding refers to generating the software product's detailed instructions in computer language. These make the computer perform all that has been called for in the detailed program design. Testing refers to performing the steps necessary to ensure that the coded computer software is doing what it was designed to do.

At a minimum, the entity developing the software product must perform specific following activities before evidence is provided that technological feasibility has been achieved. These activities are broken into two categories based on whether or not a detailed program design has been created. A detail program design is a blueprint of a computer product's function, features, and technological requirements derived to their most detailed, logical form. The specific activities that evidence technological feasibility are:

- If the software product development process includes a detail program design:
 - The product design and detail program design are completed, and the entity developing the software has established that the necessary skills, hardware, and software technology are available to it to produce the product. The product design is a logical enumeration of all the product functions and serves as the product specifications.
 - The consistency between the product design and detail program design and the completeness of the latter has been confirmed by documenting and tracing the detail program design to the product specifications found in the product design.
 - The detail program design has been reviewed for what are termed high-risk development issues, such as novel, unique, or unproven functions and features and technological innovations. Assurance has been derived that any uncertainties related to these issues have been resolved through coding and testing.

- If the software product development process does not have a detail program design:
 - A product design and working model has been completed. A working model is an operative version of the computer software product that will be marketed. It is written in the same software language as the computer software product and performs all the functions planned for the product.
 - The completeness of the working model and its consistency with the product design have been confirmed by testing.

Capitalization of Computer Software Subsequent to the Establishment of Technological Feasibility

Product master production cost incurred subsequent to the establishment of technological feasibility should be capitalized. These costs generally include the performance of coding and testing. SFAS 86 indicates that no software production costs shall be capitalized until technological feasibility has been established for the software and all R&D activities for the other components of the product or process have been completed. The capitalization process should be discontinued when the product is ready and available for general release to customers.

Maintenance and customer support costs should be charged to expense when these costs are incurred or the related revenue is recognized from the product's sale. When the sales price of a computer software product includes customer support for several periods and the price of that support is not separately stated, the estimated cost of the customer support should be accrued in the same period that the sales revenue is recognized.

Purchased Computer Software with No Alternative Future Uses

The cost of purchased computer software that is to be sold, leased, or otherwise marketed and that has no alternative future uses should be charged to expense in the period of acquisition like R&D expenditures. If, on the other hand, the purchased software has alternative future uses, it should be capitalized and amortized based on its future expected application.

Amortization of Capitalized Software Costs

Capitalized software computer costs should be amortized on a product-by-product basis. FAS-86 requires that the annual amortization that is recognized should be based on the greater of the following two computations after the product is available for general release to customers:

1. Result derived by computing the ratio of current gross revenues of the product to its current and anticipated gross revenues.
2. The straight-line method taken over the remaining estimated economic life of the product, including the period being reported on.

Duplication Costs Charged to Inventory

All costs incurred in duplicating the computer software and related materials (e.g., documentation and training materials) from the product masters as well as the physical packaging needed for its distribution should be recorded as inventory on a unit-specific basis. When the sale of the unit is recognized, the cost of the inventory should also be recognized and charged to the cost of sales. If the unit is unsold, its costs remains as unsold inventory.

End-of-Period Evaluation and Disclosure on the Financial Statements

At each balance date, the unamortized capitalized costs of the computer software product should be compared to its net realizable value. Any excess of the unamortized capitalized computer product over its net realizable value should be written off. The amount of the write-off should not be subsequently restored. In addition, the remaining unamortized capitalized computer software costs at the close of the entity's annual fiscal period then become its new cost for subsequent accounting periods.

SFAS 86 requires that the following disclosure requirements be satisfied relating to computer software costs each period:

- Unamortized computer software costs should be included in each balance sheet presented.
- The total amount that was charged to expense should be disclosed in each income statement presented (e.g., amortization of capitalized computer software costs as well as the amounts that were written off in bringing the amortized costs down to their net realizable values).

RELATED EITF ISSUES

The following are titles issued by the Emerging Issues Task Force (EITF) relating to topics on the development of computer software to be sold, leased, or otherwise marketed:

- Issue No. 96-6 (*Accounting for the Film and Software Costs Associated with Developing and Educational Software Products*).
- Issue No. 00-2 (*Accounting for Web Site Development Costs*).
- Issue No. 00-3 (*Application of AICPA Statement of Position 97-2 to Arrangements That Included the Right to Use Software Stored on Another Entity's Hardware*).
- Issue No. 00-20 (*Accounting for Costs Incurred to Acquire or Originate Information for Database Content and Other Collections of Information*).
- Issue No. D-71 (*Accounting Issues Relating to the Introduction of the European Economic and Monetary Union [EMU]*).

CHAPTER 6

ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Identify the costs incurred in the three stages of software development.
- Discuss when to expense or capitalize costs.

TERMINOLOGY

Research and development expenditures. They include (1) internally developed software used for a particular current research and development project as well as (2) purchased or leased software that is used in research and development activities of the entity that do not have any alternative future uses.

SOURCES OF GAAP

- AICPA Statement of Position No. 98-1 (*Accounting for the Costs of Computer Software Developed or Obtained for Internal Use**).

*Statements of Position are publications of the AICPA's Accounting Standards Executive Committee (Ac- SEC). Under SFAS 69, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditors Report*, Statements of Position are not construed as Generally Accepted Accounting Principles covered by Rule 203 of the AICPA's Code of Professional Ethics.

- SFAS 2 (*Accounting for Research and Development Costs*).

RULES, CONCEPTS, AND ILLUSTRATIONS

Accounting guidance in the area of computer software developed or obtained for internal use is primarily provided by Statement of Position No. 98-1 (SOP 98-1), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. This statement outlines the steps that must be followed in accounting for software that has been acquired, internally developed or modified for the specific purpose of meeting an entity's internal needs. Throughout the software development process, it is assumed that the entity has no plan or that no plan is being developed to market the software externally.

The statement discusses three stages of computer software development that are applicable: the preliminary project; application development; and post-implementation/operation. During the preliminary project and post-implementation/operation, costs incurred are to be expensed in the period they are incurred. During application development, costs incurred should be capitalized.

AUTHORITATIVE GUIDANCE

SOP 98-1 discusses the parameters of accounting for the costs of computer software developed or obtained for internal use—that is, to meet an entity’s internal needs rather than for external marketing purposes. In general, any internally used computer software that was utilized in the research and development activities of an entity should be accounted for in conjunction with SFAS 2, *Accounting for Research and Development Costs*.

As mentioned, SOP 98-1 establishes three stages of computer software development for internal use, as discussed in the following paragraphs.

Preliminary Project Stage—During this stage, the entity is in the midst of evaluating alternatives regarding the software project and has not yet determined which strategy or which vendor to use. Activities that occur during this stage include assembling the evaluation team, evaluating proposals from vendors, and determining whether other related reengineering needs can be satisfied. All costs incurred during this period should be expensed as incurred.

Application Development Stage—This stage commences when management decides how the internal software development work will be performed. From this chronological point, all costs incurred to develop or obtain computer software for internal use are required to be capitalized and treated as a long-lived asset. Capitalization should begin when the following occur:

- The preliminary project stage has been completed, and
- Management commits to funding a computer software project. It is believed that the completion of this project is probable and that it will be used to perform its intended function.

The capitalization of costs should terminate when the software is complete and ready for use. Typical costs that should be capitalized include any direct material or services contributing to the project, payroll costs, any interest costs that were incurred during the development process, and testing and installation software costs. (**Note:** General and administrative costs, training, and overhead should not be capitalized as costs of the computer software.)

Postimplementation/Operation Stage—This stage commences once the internal use software is put into use. In addition, the costs that have been capitalized should be amortized over the period that is expected to be benefited. In general, capitalized cost should be amortized on a straight-line basis over the estimated useful life of the internally used software. The estimated useful life of this software is commonly short and should be frequently reassessed considering the obsolescence, competition, and other factors.

It is possible for a company to decide to subsequently market the computer software that it developed for internal use. If this occurs, the entity should not recognize

any profit until the aggregate proceeds from the sales of the software exceeds its carrying amount. All subsequent proceeds received should be recognized as being earned.

RESEARCH AND DEVELOPMENT COSTS

If costs are incurred for computer software that is used internally for research and development activities, these costs should be accounted for in accordance with the guidance of SFAS 2, *Accounting for Research and Development Costs*. For example, research and development expenditures include (1) internally developed software used for a particular current research and development project as well as (2) purchased or leased software that is used in research and development activities of the entity that do not have any alternative future uses.

CHAPTER 7 FRANCHISES

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Discuss how to accounting for revenue from individual franchise sales.
- Explain how to accounting for revenue from area franchise sales.
- Outline contractual arrangements between franchisor and franchisee.
- Allocate initial franchise fee and continuing franchisee fees.
- Describe product sales made to a franchisee on a continuing basis.
- Define agency sales.
- State how to account for franchising costs.
- Detail required disclosures relating to franchisors.

TERMINOLOGY

Franchise. A contractual arrangement whereby a franchisor grants business rights and provides services to a franchisee who in return agrees to pay an initial franchise fee to operate a business and pay continuing fees based on the operations of the business.

Franchisee. The party who operates the franchised business.

Franchisor. The party who grants business rights under the franchise.

Initial franchise fee. Consideration for establishing the franchise relationship and providing some initial services.

SOURCES OF GAAP

The key source of authoritative GAAP relating to guidance in accounting by franchisors is:

- SFAS 45 (*Accounting for Franchise Fee Revenue*).
- SFAS 141 (*Business Combinations*).
- EITF Issue No. 00-21 (*Accounting for Revenue Arrangements with Multiple Deliverables*).

RULES, CONCEPTS, AND ILLUSTRATIONS

A franchise is a written business agreement in which a franchisor, for a specified period and delineated geographical area, allows a franchisee to use certain trade names and trademarks, sell certain products, and perform certain services for which the franchisor has exclusive legal rights. The franchisor is the entity that grants the rights under the franchise contract to the franchisee, who then operates the franchised business and, in turn, compensates the franchisor for the privilege. SFAS 45 discusses the accounting and reporting requirements from the perspective of the franchisor. Individual and area franchise sales should be recognized as franchise fee revenue when all material services or

conditions related to the sale have been substantially performed and satisfied by the franchisor. Other areas of the standard for which guidance is rendered are contractual arrangements between franchisor and franchisee, allocation of initial franchise fee, continuing franchise fees, product sales made to franchisee on a continuing basis, agency sales, franchising costs, repossessed franchises, business combinations, and required disclosures.

KEY GAAP

Accounting for Revenue from Individual Franchise Sales

Franchise fee revenue from individual franchise sales should be recognized when the franchisor has substantially performed and satisfied all material services or conditions relating to the sale. SFAS 45 indicates that *substantial performance on the part of the franchisor* means:

- There is no obligation or intent to refund any cash received or forgive any unpaid notes or receivables.
- All initial services that the franchisor was contractually required to do by the signed franchise agreement have been completed.
- No significant responsibilities related to substantial performance by the franchisor remain.

In addition, a provision for estimated uncollectible initial franchise fees should be recorded to ensure a proper matching of revenues and costs. In exceptional cases, when franchise fee revenue is collected over an extended period and no reasonable basis exists for estimating collectibility, it may be necessary to use the installment or cost recovery methods to account for revenue recognition.

Unless there are unusual circumstances, substantial performance cannot take place before the franchisee starts his or her operation. Often, a franchise agreement calls for a large initial franchise fee and relatively small continuing franchise fees providing for future services that the franchisor agrees to perform throughout the term of the franchise agreement. If it is determined that the continuing fee will not cover the cost of the continuing services performed by the franchisor as well as earning a reasonable profit, then a portion of the initial franchise fee should be deferred and subsequently amortized over the life of the franchise. That is, the portion of the initial franchise fee that is deferred should be sufficient to cover the estimated cost in excess of continuing franchise fees and the earning of a reasonable profit on the continuing services themselves.

Accounting for Revenue from Area Franchise Sales

An area franchise is an agreement that transfers franchise rights within a geographical area, permitting the opening of a number of franchised outlets. A franchisor may sell an area franchise to a franchisee, who may decide to operate the franchised outlets, or the franchisor may sell an area franchise to an intermediary franchisee, who then may decide to sell the individual franchises to other franchisees who will operate the outlets. Sometimes the cost and efforts relating to the initial services performed by the franchisor are not affected by the number of outlets opened in an area, and therefore the area franchise sale is

very similar to an individual franchise sale. In that situation, any initial franchise fees relating to area franchise sales should be accounted for in the same manner as individual franchise sales, and substantial performance on the part of the franchisor should be evaluated using the same parameters.

However, when the efforts and total cost related to the initial services are materially affected by the number of outlets opened in an area, it may be necessary to view the area franchise agreement differently. In this circumstance, an area franchise agreement should be viewed as a divisible contract, and area franchise fees should be recognized in proportion to the number of outlets opened. For example, the more the outlets that are opened, the proportionally greater part of the area franchise fee should be recognized (assuming substantial performance has taken place). This may require an estimate on the part of the franchisor regarding the expected number of outlets guided by, perhaps, the minimum or maximum outlets indicated in the franchise contract. Any change in estimate resulting from a change in circumstance should result in recognizing the remaining fees as revenues in proportion to the remaining services that have yet to be performed.

Contractual Arrangements Between Franchisor and Franchisee

A franchisor and franchisee may have several contractual business relationships outstanding at any given point in time. For example, a franchisor may have guaranteed the borrowings of a franchisee, have a creditor interest in the franchisee, or control a franchisee's operations by sales or other agreements. The extent of these associations may effectively make the franchisee an affiliate of the franchisor. This relationship (between franchisor and franchisee) does not change the GAAP requirement that revenue should not be recognized if all material services, conditions, or obligations relating to the sale have not been substantially performed or satisfied.

A franchisor may have an option (delineated in the franchise agreement) to purchase a franchisee's business. A franchisor may choose to repurchase a franchise business because it is profitable or because it is having financial difficulties or other problems that may tarnish the reputation and goodwill of the entire franchise system. If such an option exists, the likelihood of the franchisor's acquiring the franchised business should be considered in accounting for the initial franchise fee. If it is probable that the franchisor will eventually repurchase the franchise, the initial fee must be deferred and considered as a reduction of the repurchase price when the option is exercised.

Allocation of Initial Franchise Fee

A franchise agreement commonly establishes an initial franchise fee that is to be paid to a franchisor for the franchise rights and services that are to be performed by the franchisor. However, that fee may also include the sale of such tangible property as franchise signs, equipment, inventory, land, and buildings. In this situation, a portion of the fee related to the sale of the tangible assets based on their fair market value may be recognized before or after recognizing the portion applicable to the initial services. For example, a franchisor may recognize a portion of the fee related to the sale of specific tangible assets when their title passes although the balance of the fee relating to services would be recognized as revenue when those services have been substantially performed or satisfied.

A franchise agreement may specify that certain portions of the franchise fee relate to specific services that the franchisor will provide the franchisee. If, however, the services that the franchisor will provide are interrelated to such an extent that the amount that applies to each service cannot be objectively segregated, the revenue for a specific purpose should not be recognized until all services noted by the franchise agreement are substantially performed. If, on the other hand, transaction prices for the services are available, a part of the revenue may be recognized when that service is performed.

Continuing Franchise Fees

A franchisee may be contractually required to pay continuing franchise fees to a franchisor for the continued use of the franchised rights as well as for services performed by the franchisor. These fees should be reported by the franchisor as revenue as the fees are earned and become a receivable to the franchisor. In addition, any costs incurred by the franchisor related to the franchise fees should be expensed as incurred. The earnings process must be honored even though a portion of the continuing fee is designated for a particular purpose, such as an advertising program. It should not be recognized as revenue until the fee is earned and becomes receivable from the franchisee. An exception exists when a franchise arrangement is an agency arrangement under which a portion of the continuing fee is required to be segregated and used for a special purpose. In this situation, the segregated amount should be recorded as a liability by the franchisor against which costs incurred by the franchisee would be charged.

Product Sales Made to Franchisee on a Continuing Basis

In the course of franchisee operations, the franchisee may purchase some or all of its supplies and equipment from the franchisor. As part of this arrangement, the franchisee may be given the right to purchase these items at a bargain price. If this price is lower than the selling price of the product to other customers or the price that is paid does not generate a reasonable profit on the equipment or supplies, a portion of the initial franchise fee should be deferred and accounted for as an adjustment of the selling price when the equipment or supplies are purchased. The portion deferred should be one of the following:

- The difference between the selling price of the equipment or products and the bargain purchase price that the franchisee is receiving.
- An amount that would cover any cost in excess of the bargain purchase price and provide a reasonable profit to the franchisor.

Accounting for Agency Sales

Some franchisors may act as an agent for franchisees by placing orders for inventory and equipment and selling them to franchisees at no profit. Franchisors involved in such transactions should account for these transactions as receivables and payables and not as revenues and expenses.

Franchising Costs

Direct costs relating to franchise sales should be recognized in the same accounting period as the revenue that they helped generate. If revenue is not yet recognized, costs incurred

should be deferred until it is. However, deferred costs shall not exceed anticipated revenue less estimated additional estimated costs. Indirect costs of a regular and recurring nature that are incurred independent of the level of sales—such as general, administrative, and selling costs—should be expensed as incurred.

Reposessed Franchises

If a franchisee decides not to open a franchise business, a franchisor may recover the franchise rights through repossession. If repossession occurs, two possible outcomes may occur. The franchisor may decide to refund or not refund the money received from the franchisee. A description of the contingencies follows:

- *A refund is made.* If the franchisor refunds the franchisee's money, the original sale is canceled and the revenue previously recognized is accounted for as a reduction in revenue in the period in which the franchise is reposessed.
- *No refund is made.* If the franchisor does not refund the franchisee's money:
 - The transaction should be regarded as a canceled sale.
 - No adjustment should be made to any previously recognized revenue.
 - Any uncollectible amounts resulting from receivables that have not been paid should be accounted for and a provision for bad debts should be provided for.
 - Any money that was previously received and accounted for as deferred revenue should now be recognized as earned revenue.

Business Combinations

If a franchisor acquires an operating business from a franchisee, it should be accounted for as a business combination in accordance with SFAS Statement 141, *Business Combinations*. However, if such an acquisition results in the cancellation of an original franchise, then it should be accounted for as a reposessed franchise. (See previous section, "Reposessed Franchises.")

Required Disclosures on the Financial Statements or Notes

SFAS 45 requires that the following information be disclosed in the body of the franchisor's financial statements or notes:

- The nature of all significant commitments and obligations resulting from the franchise agreement, including a description of the services that the franchisor has agreed to provide but has not yet substantially performed.
- If no basis exists for estimating the collectibility of specific franchise fees, the notes to the financial statements should disclose:
 - Whether the installment or cost recovery method is being used to account for the related franchise fee revenue.
 - The sales price of the franchise.
 - Revenue and related costs deferred both currently and on a cumulative basis.

- The periods in which the franchise fees become payable by the franchisee.
 - Amounts that were originally deferred but later recognized because the uncertainty relating to the franchise fee's collectibility was resolved.
- If material, initial franchise fees should be separated from other franchise revenue.
 - Predictable decline in future initial franchise fee revenues because sales have reached a saturation point. (This disclosure is desirable but not required.)
 - Separate disclosure of the amount of initial franchise fees relative to the amount of net income when such amounts are not apparent. (This disclosure is desirable but not required.)
 - Revenue and costs related to franchisor-related businesses should be shown separately from those related to franchisee related businesses when practicable.
 - If there are significant changes in the ownership of franchisor-owned outlets or franchised outlets during the period, the following should be disclosed:
 - Number of franchises sold.
 - Number of franchises purchased during the period.
 - Number of franchised outlets in operation during the fiscal year.
 - Number of franchisor-owned outlets in operation during the fiscal year.

CHAPTER 8

FINANCE INDUSTRY

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- State how to account for loan origination fees and related costs.
- Explain how to account for commitment fees and costs.
- Discuss how to account for purchase of a loan or group of loans.
- Measure loans subject to prepayment.
- Describe how loan origination fees and related costs are reported on the income statement and balance sheet.

TERMINOLOGY

Accounts receivable loan. A loan collateralized by the accounts receivable of the borrower.

Dealer reserves. Finance company liabilities for dealers' shares of finance charges on retail contracts purchased from dealers.

Direct consumer loan. A two-party transaction in which the finance company lends funds directly to the borrower; such a loan may or may not be collateralized.

Discount. Amount deducted from the face value in advance as a charge for the loan or a deduction for interest at the time of the loan or any charge for credit that is precomputed and included in the face of the instrument.

Discount factoring. See **factoring**.

Discount loan. A loan that is written with the interest or finance charges included in the face amount of the note. Discount loans are also called precompute or add-on loans.

Effective interest rate. The implicit rate of interest based on the amount advanced and the amount and timing of the specified repayments over the period of the contract.

Factor. A company that engages primarily in factoring.

Factoring. Purchase, usually without recourse, of individual accounts receivable arising in the client's ordinary course of business. Under a factoring agreement, the finance company also provides credit checking, collection and recordkeeping services.

Floor plan checking. Physical inspection of dealer's inventories that are collateral for advances to the dealer to be repaid from the proceeds from sale of specific items. Sometimes referred to as floor plan auditing.

Floor planning. Financing of dealers' inventories, particularly automobiles and other consumer goods, sometimes referred to as wholesaling. The dealers are obliged to repay the supplier or manufacturer from proceeds of sale of specific items, or after an elapsed period even though inventory is not sold.

Interest-bearing loan. A loan that is written at the principal amount advanced to the borrower and bearing interest computed monthly on the unpaid balance.

Interest method. A method of computing income under which interest income on a fixed-rate obligation is accrued over the life of the loan based on a constant rate (percent) of interest applied to the outstanding loan balance. As a result, the amount of income recognized at a given time is directly proportional to the outstanding loan balance. Also called the actuarial method.

Inventory loan. A loan collateralized by inventory of the borrower.

Nonrefundable fee. Any charge made in connection with a loan that does not have to be refunded to the borrower when the loan is prepaid.

Origination fee. An amount charged by finance companies for originating, refinancing, or restructuring a loan. The amount may be intended to cover costs such as underwriting, loan application processing, and reviewing legal title to property involved.

Overadvance (in factoring). An amount advanced to a client in excess of the amount of uncollected receivables purchased by the factor.

Points. Amounts, generally expressed as a percent of the loan, charged for granting loans, that primarily are adjustments of yield but also may be intended to cover costs such as underwriting, loan application processing, and reviewing title to collateral.

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in the finance industry are:

- SFAS 91 (*Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*).
- SFAS 115 (*Accounting for Certain Investments in Debt and Equity Securities*).
- SFAS 124 (*Accounting for Certain Investments Held by Not-for-Profit Organizations*).
- SFAS (*Accounting for Transfer and Servicing of Financial Assets and Extinguishments of Liabilities*).

RULES, CONCEPTS, AND ILLUSTRATIONS

Accounting in the finance industry relates to accounting for nonrefundable fees associated with lending or purchasing a loan or a group of loans. The concepts enumerated here apply to all types of loans or lenders. Overall, following are the salient matters of the area:

- Loan origination fees should be recognized over the term of the related loan as an adjustment of yield.
- Some direct loan origination costs should be recognized over the term of the related loan as a reduction of its yield.
- In general, all loan commitment fees should be deferred except for certain retrospectively determined fees. Specifically, commitment fees that meet certain conditions, should be recognized over the loan commitment period. All other commitment fees should be recognized as an adjustment of the yield over the related loan life. If the commitment expires and is not exercised by the lender, the loan commitment fee should be recognized in income at the date of the commitment's expiration.
- The following should be recognized as an adjustment of yield by the interest method based on the contractual terms of the loan: loan fees; certain direct loan origination costs, and purchase premiums and discounts on loans.

KEY GAAP

Loan Origination Fees and Related Costs

An entity may acquire a loan by lending or by purchasing. Acquiring a loan by lending is called originating a loan. Acquiring one by purchasing is known as acquiring the loan from a party or other borrower. Loan origination fees should be deferred and recognized over the life of the loan as an adjustment of its yield resulting in an adjustment of interest income. Direct loan origination costs should also be deferred and recognized as a reduction in the yield of the loan. Direct loan origination costs should include only the following:

- Incremental direct costs of the loan origination incurred in transactions with independent third parties for that loan.
- Certain costs directly related to the loan performed by the lender, such as evaluating the potential buyer's borrower's financial condition, evaluating and recording guarantees, collateral, and other security arrangements.

All other lending-related costs include costs related to activities performed by the lender for such activities as advertising, soliciting potential borrowers, servicing existing loans, and other activities related to establishing and monitoring credit policies, supervision, and administration. These costs should be charged to expense as incurred.

Commitment Fees and Costs

In general, fees received for a commitment to originate or purchase a loan or group of loans should be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of the related loan's yield. If the commitment expires, unused, the fee should be recognized in income at the date of the expiration of the commitment. There are two exceptions to this general rule:

1. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period; if that percentage is nominal in relation to the stated interest rate on any related borrowing; and if that borrowing will bear a market interest rate at the date the loan is made, the commitment should be recognized as service fee income as of the determination date.
2. If it is determined by the lending entity that the likelihood of commitment exercise is remote, the commitment fee should be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is, in fact, subsequently exercised over the commitment period, the remaining unamortized commitment fee at the time of exercise should be recognized over the term of the loan as an adjustment of its yield.

Direct loan origination costs incurred to make a commitment to originate a loan should be offset against any related commitment fee and the net amount recognized as a commitment fee, described previously.

Purchase of a Loan or Group of Loans

If a loan or group of loans are purchased, the initial investment should include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of the purchase. The amount (difference) should be recognized as an adjustment of the yield over the life of the loan. All other costs incurred in connection with acquiring a purchased loan or committing to purchase loans should be charged to expense as incurred. If loans are purchased as a group, the purchaser may either allocate the initial investment to the individual loans making up the group or may account for the initial investment in the aggregate. Deferred net fees or costs should not be amortized during the periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

Measurement of Loans Subject to Prepayment

Interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment should be subsequently measured in debt securities and classified as available-for-sale securities or as trading securities under SFAS 115.

Income Statement Classification

SFAS 91 requires that the loan origination, commitment, and other fees and costs that are recognized as an adjustment of loan yield should be reported as interest income. Amortization fees, such as commitment fees that are being amortized on a straight-line basis over the commitment period or included in income when the commitment expires should be reported as service fee income.

Balance Sheet Classification

SFAS 91 requires that the unamortized balance of loan origination, commitment, and other fees and costs and purchase premiums and discounts that are being recognized as an adjustment of yield should be reported on the balance sheet of the enterprise as part of the loan balance that it relates to.

CHAPTER 9 GOVERNMENT CONTRACTS

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Outline issues in accounting for cost plus fixed fee contracts
- Determine when to recognize profits on such contractsDiscuss the accounting problems arising under cost-plus-fixed-fee (CPFF) contracts.
- Renegotiate government contracts.
- Outline government contract disclosures.
- Explain terminated war and defense contracts.
- Detail termination claims disclosure requirements.

TERMINOLOGY

Contractors. Include prime contractors and subcontractors.

Contracts. Refer to prime contracts and subcontracts.

Cost-plus-fixed-fee contracts. Provide for contractors to receive a specified fixed fee and to be reimbursed for their allowable costs. Because title passes to the government and the contractor obtains an unconditional right to partial payment prior to delivery, delivery of the finished product is not necessarily evidence of performance.

Disposal Credits. Deductions from the termination claim receivable for approved retention or sale of inventory previously included in the claim.

No-cost settlements. Settlements in which the contractor waives the right to make a claim. No sale should be recorded and applicable costs should retain their usual classification.

Service contracts. Contracts in which the contractor acts only as an agent.

Supply contracts. Contract in which the contractor's services extend beyond that of an agent. Contracts include services such as the use of the contractor's own facilities and responsibility to creditors for material and services, and to employees for salaries.

Subcontractor's claims. Claims made in conjunction with a terminated contract are costs for the terminated contract that do not result in the transfer of billable materials or services to the contractor before termination.

SOURCES OF GAAP

The key source of authoritative GAAP relating to guidance in government contracts is:

- Accounting Research Bulletin (ARB) No. 43 (*Restatement and Revision of Accounting Research Bulletins*), Chapter 11, “Government Contracts.”

RULES, CONCEPTS, AND ILLUSTRATIONS

Chapter 11 of ARB Bulletin No. 43 deals with the accounting problems arising under cost-plus-fixed-fee (CPFF) contracts. Fees received under government CPFF contracts should be credited to income on the basis of partial performance, assuming reasonable assurance that realization has taken place. Billable fees may also be accrued as income unless the accrual is not reasonably related to the proportionate performance of the total work or services.

Contractor profit in a fixed-price supply contract that is unilaterally terminated by the government accrues as of the effective date of the termination. That is, the contractor in such a situation is entitled to reimbursement for all costs plus a fair portion of the fixed contractual fee.

KEY GAAP

Government contracts are generally prepared on a CPFF structure, which allows for possible renegotiation if the government believes that the contract has been generating excess profits. In addition, the government usually reserves the right in these agreements to terminate the contract at its convenience.

CPFF contracts allow the contractor to collect a fixed fee from the government as well as all costs incurred required to satisfy the contract. The government in contracting for the construction of some product or the performance of services may choose at its discretion to withhold a certain percentage of payments due on the contract while the work is being performed. If the government should choose to terminate the contract for a given reason, the contractor is entitled to be repaid for all costs incurred as well as a proportionate part of the contracted fixed fee.

From the contractor’s point of view, the primary accounting problem is when to recognize profits on CPFF contracts with the government. A contractor should not recognize any profits on CPFF contracts until the services have been fully performed and accepted unconditionally by the government or the product that has been manufactured has been deemed to meet the government’s contractual standards. However, if a government contract is expected to last over an extended number of years, the contractor should use the percentage-of-completion method.

When accounting for CPFF contracts, two general rules prevail:

1. When the contract calls for only the performance of services by the contractor, all fees charged should be included in the contractor’s revenue account.
2. When the contract involves the manufacture of goods and products, contractor’s sales and revenue accounts should include the fees generated on

the project as well as all reimbursable costs.

Renegotiating Government Contracts

As previously noted, most government CPFF contracts allow the government to make adjustments of the original sales price of the contract when excessive profits are being generated by the contractor. Generally, an estimate is made and an adjustment provision is accounted for. The basis for the estimate is predicated on the government's past experiences in the industry as well as the contractor's past experiences. If a reasonable estimate cannot be made and a renegotiation of sales revenue cannot be reached, that fact should be fully disclosed in the footnotes of the contractor's financial statements. The estimate of the reduction of sales revenue should be shown in the (contractor's) income statement as either contra-sales or contra-income. The adjustment provision should be shown as a current liability on the balance sheet, assuming it will be satisfied in one year or in the operating cycle, whichever is longer. In the next accounting period, if it is determined that the estimate accounted for in the prior period was incorrect relative to the final adjustment, the change that is required should be shown in the income statement in the period in which final resolution is determined. A contractor should account for revenue on CPFF contracts using the installment method or the cost recovery method, if it is deemed that collections from the government will not be reasonably assured. However, this situation is generally very unusual.

Government Contract Disclosures

When a material portion of an enterprise's revenue is derived from government contracts, that fact must be disclosed in the financial statements or in the notes of the contractor. Specifically, disclosure is required if at least 10% of the entity's revenue is generated from contracts with the federal, state, local, or foreign government. In addition, the following disclosures should be made:

- Uncertainty exists that the provision that was made for renegotiation of the contract by the government is insufficient and additional charges may be required.
- The basis for ascertaining the provision for renegotiation should be disclosed (e.g., past experience, industry experience).

Terminated War and Defense Contracts

War and defense contracts have generally been made on both a CPFF and fixed-price basis. If the government terminates a war or defense contract, the determination of the extent of profit that should be accounted for should be made as of the effective date of the termination. The contractor, on this date, has the right to accrue any amount due from the government on the part of the contract that has been canceled. The amount of profit that should be accrued is the difference between all allowable costs that have been incurred by the contractor and the amount of the termination claim. However, most of the contracts that are signed with the government provide a minimum profit-percentage formula that should be used if an agreement regarding what should be paid by the government cannot be reached.

If a reasonable estimate of the termination claim cannot be made for reporting purposes, this fact should be fully disclosed in the notes to the financial statements, including the uncertainty involved.

Termination claims on the accounting records of the contractor should be shown as current assets. Prior to receiving these notices, advances that are paid should be deducted from termination claims receivable. Correspondingly, any loans that are received by the contractor based on the termination claims or security of the governmental contract should be disclosed separately on the contractor's balance sheet as current debt.

Sometimes a contractor reacquires items that were included in the termination claim. These items, known as disposal credits, should be recorded as a new purchase and applied as a reduction of the termination claim.

Termination Claims Disclosure Requirements

Termination claims based on governmental contracts should be classified as receivables on the balance sheet of the contractor. However, if material in amount, they must be separately disclosed from other receivables in the financial statements.

Contractors should fairly estimate the amount of the termination claim by determining the amounts that are collectible. In addition, provision should be made for those amounts whose collectibility are questionable. Of course, these items should be fully disclosed in the financial statements.

CHAPTER 10

HEALTH CARE INDUSTRY

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- List the required financial statements of the health care industry.
- Outline how to account for contributions made to not-for-profit health care entities.

TERMINOLOGY

Health Care Service Organization Classifications:

1. Investor-owned Health Care Organizations
2. Not-for-Profit, Business-Oriented Organizations
3. Governmental Health Care Organizations
4. Not-for-Profit, Nonbusiness-Oriented Organizations (voluntary health and welfare organizations); these are within the scope of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in the health care industry are:

- SFAS 105 (*Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*)
- SFAS 107 (*Disclosure about Fair Value of Financial Instruments*)
- SFAS 116 (*Accounting for Contributions Received and Contributions Made*)
- SFAS 117 (*Financial Statements for Not-for-Profit Organizations*)
- SFAS 124 (*Accounting for Certain Investments Held by Not-for-Profit Organizations*)
- SFAS 125 (*Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*)
- FASB Interpretation 42 (*Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power*)
- AICPA Audit and Accounting Guide (*Health Care Organizations*)

RULES, CONCEPTS, AND ILLUSTRATIONS

Accounting in the health care industry consists of reporting on the financial statements of enterprises whose primary functions consist of providing health care services to individuals. Financial statements of health care entities should be prepared in conformity with GAAP. Governmental health care entities should prepare their financial statements in accordance with Governmental Accounting Standards Board (GASB) statements and their

interpretations as well as in accordance with SFAS, APB, and other related pronouncements required by the GASB. In general, health care service organizations are classified in the following manner:

1. Investor-owned health care entities
2. Not-for-profit, business entities
3. Governmental health care entities
4. Not-for-profit, nonbusiness entities (voluntary health care and welfare organizations (not covered))

KEY GAAP

Required Financial Statements

Investor-owned health care enterprises are required to prepare the same financial statements as those of any investor-owned enterprise. Not-for-profit and governmental health care entities, on the other hand, are required to prepare the following financial statements:

1. Statement of operations
2. Statement of financial position
3. Statement of changes in equity (or net assets/fund balance)
4. Statement of cash flows
5. Notes to the financial statements

SFAS 95 (*Statement of Cash Flows*), and GASB Statement Number 9 (*Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities*), establish the required guidelines for reporting cash flows for investor owned entities as well as governmental health care enterprises. In both groups, the direct method is considered the preferable method; however, the indirect method of reporting for cash flows is allowed. The statement of cash flows should always be reported in cash and cash equivalents. In addition, entities' balance sheets must disclose (1) total assets, (2) total liabilities, and (3) net assets.

The last category should, in turn, be subdivided into the following groups:

1. Unrestricted
2. Temporarily restricted or
3. Permanently restricted

These categories should also be used to report changes in equity in the statement of changes in equity.

Organizations that are not for profit require all the information of GAAP as well as other specialized requirements. For example, not-for-profit entities must fully disclose the information relating to the following items and areas:

1. Financial instruments
2. Contingencies

3. Extraordinary items
4. Cumulative effect of a change in accounting principle

For all of the aforementioned areas and in general, presentation and order in the financial statements should parallel that of profit-generating entities.

Health care entities should record all revenue on an accrual basis. This often requires that certain adjustments be accounted for and then deducted from gross revenue to derive what is termed net service revenue. The amount that should be recorded is the amount that the health service enterprise is contractually entitled to. Revenue payments to providers generally come from health insurance companies, Medicare, and Medicaid. Although not included in revenue, a health care provider should fully disclose the level of charity care it provides. Health care revenues include health care services revenues and other revenues. The latter are derived from services other than health care provided to patients and residents, as well as sales and services to nonpatients. Other revenues may include cafeteria sales, tuition from educational programs, donated medicine, and office space rentals. However, contributions either unrestricted or for a specific purpose, are treated as gains unless fund-raising is an ongoing major activity of the hospital.

Contributions Made To Not-For-Profit Health Care Entities

The following are some general guidelines that should be followed in accounting for contributions made to not-for-profit health care entities.

Contributions made should be disclosed as resulting in increases in net assets from amounts that are

1. permanently restricted
2. temporarily restricted or
3. unrestricted

In health care organization accounting, the term "restricted" is used to describe resources that have been restricted as to their use by the donors or grantors of those resources. Temporarily restricted net assets are those donor-restricted net assets that can be used by the not-for-profit organization for their specified purpose once the donor's restriction is met. Permanently restricted net assets (for example, endowment funds) are those with donor restrictions that do not expire with the passage of time and cannot be removed by any actions taken by the entity.

Contributed collections consisting of historical works, art, etc., that are held for education, research, or public exhibition are not required to be capitalized and recognized as revenue in the financial statements.

Contributions in service should not be recognized in the financial statements unless the following conditions are met:

1. Individuals providing the service contribution are qualified to do so with unique,

- specialized skills.
2. The service contribution resulted in the production or enhancement of nonfinancial assets.

Some not-for-profit health care entities are charitable enterprises that must conform with donor and grantor fiduciary responsibilities and guidelines. Therefore, these entities must use fund accounting in preparing their financial statements.

CHAPTER 11

INSURANCE INDUSTRY

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Classify insurance contracts.
- Explain how to recognize premium revenue for short-duration and long-duration.
- Explain the accounting for recognition of claim costs.
- Outline the accounting procedure for catastrophe losses of property and liability insurance enterprises.
- Differentiate between contracts where significant insurance risk is assumed versus contracts without such risk.
- Describe how to account for acquisition costs.
- Outline accounting for investments of an insurance entity.
- Explain the disclosure requirements in the financial statements.

TERMINOLOGY

Insurance transaction. Transaction in which (1) the purchaser of an insurance contract makes an initial payment or deposit to the insurance company in advance of the possible occurrence or contingency and (2) the insurance company does not know if, how much, or when amounts will be payable to the insured when the insurance contract is consummated.

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in the Insurance Industry are:

- SFAS 5 (*Accounting for Contingencies*).
- SFAS 60 (*Accounting and Reporting by Insurance Companies*).
- SFAS 91 (*Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*).
- SFAS 97 (*Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*).
- SFAS 109 (*Accounting for Income Taxes*).
- SFAS 113 (*Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*).
- SFAS 114 (*Accounting by Creditors for Impairment of a Loan*).
- SFAS 115 (*Accounting for Certain Investments in Debt and Equity Securities*).
- SFAS 120 (*Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*).

- SFAS 124 (*Accounting for Certain Investments Held by Not-for-Profit Organizations*).
- SFAS 133 (*Accounting for Derivative Instruments and Hedging Activities*).
- SFAS 135 (*Rescission of SFAS No. 75 and Technical Corrections*).
- SFAS 140 (*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*).
- SFAS 144 (*Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*).
- SFAS Interpretation No. 40 (*Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*).
- Additional Guidance: Related FASB Staff Positions or questions and answers previously issued as FASB Staff Implementation Guides.

The following are titles issued by the Emerging Issues Task Force (EITF) relating to topics on the insurance industry:

- Issue No. 92-9 (*Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*).
- Issue No. 93-6 (*Accounting for Multiple-Year Retrospective Rated Contracts by Ceding and Assuming Enterprises*).
- Issue No. 93-14 (*Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises*).
- Topic No. D-35 (*SFAS Staff Views on Issue No. 93-6, "Accounting for Multiple-Year Retrospective Rated Contract by Ceding and Assuming Enterprises"*).
- Topic No. D-41 (*Adjustments in Assets and Liabilities for Holding Gains and Losses as Related to the Implementation of SFAS 115*).
- Topic No. D-54 (*Accounting by the Purchaser for a Seller's Guarantee of the Adequacy of Liabilities for Losses and Loss Adjustment Expenses of an Insurance Enterprise Acquired in a Purchase Business Combination*).
- Topic No. D-79 (*Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises*).

RULES, CONCEPTS, AND ILLUSTRATIONS

Insurance is purchased to provide economic protection from identified risks occurring within a specified period. Types of risks usually covered by insurance include death, damage, injury to others, and business interruption. In general, an insurance transaction may be identified as one in which (1) the purchaser of an insurance contract makes an initial payment or deposit to the insurance company in advance of the possible occurrence or contingency and (2) the insurance company does not know if, how much, or when amounts will be payable to the insured when the insurance contract is consummated.

Insurance contracts also may be classified as either short-duration or long-duration contracts. Long-duration insurance contracts are expected to remain in force for an extended period, such as whole life, universal life, guaranteed renewable term life, endowment, annuity, title insurance, and participating life insurance contracts.

Long-duration contracts with terms that are not fixed and guaranteed (i.e., more flexible contracts) are called universal-life-type contracts. Short-duration contracts (the remainder) consist mainly of property and liability contracts.

Insurance contracts that do not involve the assumption of significant insurance risks by the insurance company are referred to as investment contracts and are not accounted for as insurance. These should be accounted for as interest-bearing financial instruments.

Premiums from long-duration contracts that are not universal-life-type contracts are recognized as revenue when they are due from policyholders over the premium paying periods. Premiums that are collected on universal life-type contracts are not recognized nor reported as revenue. Rather, contract services assessments (based on contract benefits for policyholders) are recognized as revenue in the period of assessment. Amounts that policyholders are assessed representing compensation for the insurer's performance of future periods should be reported as unearned revenue and recognized in the period benefited. Short-term duration contract premiums are recognized as revenue evenly as insurance protection is provided. Claim costs (including estimates of costs for claims relating to events that have occurred but have not been reported to the insurer) are recognized when the insured event occurs.

Universal-life type contract acquisition costs are capitalized and amortized in proportion to the gross profit amounts that are derived from the operations of these contracts. Any costs that are incurred relating to the acquisition of insurance contracts other than universal-life type contracts should also be capitalized. However, these costs should be charged to expense in proportion to the premium revenue derived from these contracts.

Insurance companies that reinsure insurance contracts should account for their reinsurance receivables and prepaid reinsurance premiums as assets. Guidelines for the accounting and reporting standards used in recording and disclosing these types of transactions are fully described.

KEY GAAP

Classification of Insurance Contracts

In general, insurance contracts are classified as short-duration or long-duration (including universal-life-type contracts). SFAS 60 discusses each category as set forth in the following paragraphs.

Short-duration contracts Most property and liability insurance contracts are considered short duration. These contracts cover expected claim costs resulting from insured events that occur during a fixed period of short duration. The insurance company, in this situation, has the right to cancel the contract or revise the premium at the beginning of each contract period covering insured events. This enables the insurer to adjust the amount of the premiums charged or coverage provided at the end of each period. As was noted, short-duration contracts include

most property and liability insurance contracts. They also include certain term life insurance contracts, such as credit life insurance. (Credit life insurance is decreasing term insurance issued on the lives of borrowers to cover the payment of debt of the insured.) Accident and health insurance contracts, for example, may be short duration or long duration, depending on whether the contract is expected to remain in force for an extended period. *Premiums from short-duration contracts are earned and recognized as revenue evenly as the insurance protection is consumed.*

Long-duration contracts Long-duration contracts are expected to remain in force for an extended period, such as whole life, universal life, guaranteed renewable term life, endowment, annuity, title insurance, and participating life insurance contracts. These types of contracts are generally not subject to unilateral changes in their provisions. For example, policies that are of long duration may be noncancelable or may be a guaranteed renewable contract. Premiums from long-duration insurance contracts are generally level even though the policy benefits and services provided do not occur evenly over the contract periods.

They are recognized as revenue throughout the pay periods of the contract. Because this premium revenue generally exceeds the policy benefits that will be derived in the early years of the contract, the insurer is required to accrue a liability for the costs that are expected to be paid in the later years of the contract. Thus, for most types of long-duration contracts, a liability is accrued for current and expected renewal contract periods. The amount of the liability is equal to the present value of estimated future policy benefits to be paid policy holders less the present value of estimated future net premiums to be collected from policyholders. These estimates are based on several assumptions, such as investment yields, mortality, morbidity (the incidence of disability caused by disease or physical impairment), terminations, and other expenses.

Universal-life-type contracts These long-duration insurance contracts lack the fixed or guaranteed terms that are characteristic of most of the life insurance policies. They provide either death or annuity benefits and have any one of the following features:

- One or more of the amounts assessed by the insurer against the policyholder, such as amounts for mortality coverage, contract administration, initiation, or surrender, are not fixed or guaranteed by the terms of the contract.
- Amounts accruing to the policyholder, such as accrued interest on policy balances, are not fixed or guaranteed by the contract terms.
- The policyholder may vary the premiums within the contract limits and without the permission of the insurer.

Premium Revenue Recognition for Short-Duration Contracts

Premiums received from short-duration contracts should be recognized as revenue in proportion to the amount of insurance protection provided over the insurance contract period. SFAS 60 notes, however, that if the period of risk differs significantly from the contract period, revenue should be recognized in proportion to the amount of insurance provided over the period of risk. As a result, premiums are generally recognized as revenue evenly over the contract period (or period of risk if that differs from the contract period).

The only exception to the generalization is if the insurance protection declines according to some predetermined schedule. Under certain circumstances, premiums may be subject to adjustment. For example, certain insurance contracts may be experience rated. That is, the premium may be determined after the period of the contract based on the insured's claim experience. In such a situation, the premium revenue should be recognized in accordance with the following guidelines:

- If the ultimate premium can be reasonably estimated, it should be recognized as revenue over the contract period with appropriate revision to reflect the experience of the insurance company.
- If the ultimate premium cannot be reasonably estimated, the cost recovery method or deposit method should be used until the ultimate premium is reasonably estimable. Under the cost recovery method, premiums are recognized as revenue in an amount equal to estimated claim costs as insured events occur. Under the deposit method, the recognition of income is deferred until the ultimate premium can be reasonably estimated. That is, premiums are not recognized as revenue and claim costs are not correspondingly recorded as expenses until a reasonable estimate is derived of the ultimate premium that will be earned by the insurer.

Premium Revenue Recognition for Long-Duration Contracts

Premiums received from long-duration contracts should be recognized as revenue when they are due from policyholders. Long-duration contracts that typically require this recognition include whole-life contracts, guaranteed renewable term life, and title insurance contracts. In the case of title insurance, for example, the premium is considered due from policyholders on the effective date of the insurance policy. It is on this date that premium revenue should be recognized. If the binder date (the date a commitment to issue the policy is given by the insurer) is earlier, it may be used as the date of premium revenue recognition.

Premiums collected on universal-life-type contracts should be recognized as revenue in the period in which the amounts were assessed against policyholders unless the amounts collected represent compensation to the insurer for more than one period. If this is the case, the amounts received for future services should be accounted for as unearned revenue and as income in the period earned.

Recognition of Claim Costs

Unpaid claim costs, including estimates of cost relating to claims that have been incurred but not reported, should be accrued when the insured events occur. The exception to this is title insurance contracts, in which estimated claim costs (including estimates of costs) are incurred but not reported. Such claims should be accrued when title insurance premiums are recognized as revenue.

The recorded liability for unpaid claims should be based on the cost of settling the claim, which, in turn, should be based on past experience adjusted for current trends as well as any other factors that would help make past experiences more current and realistic. Changes in the estimates of claim costs due to differences between estimates and payments for claims should be recognized in the period in which the estimates are changed or payments are made. Estimated recoveries from unsettled claims, such as from salvage, subrogation, or potential interests from real estate, should be evaluated for their estimated realizable value and deducted from the recorded liability for unpaid claims. Any estimated recoveries on settled claims (other than mortgage guaranty and title insurance claims) should also be deducted from the liability on unpaid claims.

In the settlement of mortgage guaranty and title insurance claims, real estate is often acquired by the insurer. The real estate should be reported at its fair value. This is the amount that could be expected to be received in a current sale between a buyer and seller. If market value is unavailable, expected cash flows (anticipated sales price less maintenance and selling costs of the real estate) may be used in estimating the fair value of the asset. The real estate acquired in settling claims should be reported in the balance sheet separately and not categorized as an investment. If there are any subsequent reductions in the reported amount of real estate or if gains or losses are realized as a result of its sale in settling claims, these amounts should be used as an adjustment of the claim costs incurred.

Accounting for Catastrophe Losses by Property and Liability Insurance Enterprises

Property and liability insurance enterprises are entities that issue insurance contracts that protect against (1) damage to or loss of property caused by perils such as fire and theft or (2) legal liability resulting from injuries to other persons or to their property. Typically, property and liability insurance enterprises are fire and casualty insurance entities.

When a property and liability insurance entity issues an insurance policy against loss from catastrophes, it assumes a contingency relating to the risk of loss from such events. That is, it assumes the risk of loss from the occurrence of covered catastrophes that may occur during the period of the insurance contract. It incurs no potential asset impairment or liability incurrence with respect to any catastrophes that may occur beyond the insurance term.

In general, SFAS 5 requires that an estimated loss from a contingency should be accrued by a charge against income if both of the following conditions occur:

- Information becomes known prior to the issuance of the financial statements that indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
- The amount of the loss can be reasonably estimated.

Thus, in order for a loss contingency to be accrued, the possibility of catastrophic occurrence must be reasonably predictable within the insurance contract period and the amount of the loss must be reasonably estimatable. Actuarial techniques are utilized by insurance companies to predict the rate of occurrence and amounts that would have to be

paid as a result of losses from catastrophes over long periods of time for insurance rate-setting purposes. Predictions over relatively short periods of time, such as an individual accounting period or the periods of coverage of a large number of outstanding insurance contracts, are subject to significant deviations. Thus, the assumption of risk of loss by accrual (by property and liability insurance companies) relating to catastrophes fails the criteria of SFAS 5. In addition, deferral of unearned premiums within the coverage periods of “in force” insurance policies represents the unknown liability for unpaid claims, including catastrophe claim liabilities. An accrual, therefore, of an additional liability for potential losses is inappropriate under SFAS 5. Disclosure, however, of the loss contingency is required. An insurance entity should accrue a net loss on insurance contracts that will probably be incurred in excess of deferred premiums when the liability can be reasonably estimated.

Liability Accrual for Future Policy Benefits

When premium revenue is recognized, a liability for long-duration contracts (other than title insurance contracts or universal insurance) should be accrued.

The liability equals the present value of future benefits to be paid to policyholders and related expenses less the present value of future net premiums (portion of gross premiums required to provide all benefits and expenses). The liability is estimated based on expected investment yields, mortality, morbidity (the relative incidence of disability caused by disease and impairment), terminations, and other applicable expenses that are incurred at the time that the insurance contracts are consummated. Changes in the liability for future policy benefits that result from periodic estimation for financial reporting purposes should be recognized in the period in which the changes occur. It is assumed that all original assumptions continue into subsequent accounting periods for purposes of determining the liability for future policy benefits.

Liability Accrual for Universal-Life-Type Contracts

The liability for policy benefits for universal-life-type contracts should be equal to the sum of the following components:

- The balance that accrues to the benefit of policyholders at the date of the financial statements.
- Any amounts that have been assessed against policyholders to compensate the insurer for services to be performed over future periods.
- Any amounts that have previously been assessed against policyholders that are refundable as a result of the termination of the contract.
- Any probable loss (premium deficiency).

Acquisition Costs

Acquisition costs vary with, and are primarily related to, the acquisition of new and renewal insurance contracts. These costs should be capitalized and charged to expense in proportion to the revenue that is recognized. To ensure a proper matching, acquisition costs should be allocated by the insurer by categories of insurance contracts. Unamortized acquisition costs are classified on the balance sheet as an asset.

For universal-life-type contracts, capitalized acquisition costs should be amortized over the life of a book of universal-life-type contracts at a constant rate based on the present value of the estimated gross profit amounts expected to be realized over the life of such book of contracts.

The present value of estimated gross profits should be computed using the specified contract rate (i.e., the rate of interest that accrues to policyholder balances).

Premium Deficiency Recognition

Short-duration contracts A short-duration contract premium deficiency occurs if unearned premiums do not exceed the sum of related expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs. The premium deficiency should first be recognized by expensing any unamortized acquisition costs to the extent required to eliminate the deficiency. If the premium deficiency is greater than the unamortized acquisition costs, a liability should be accrued for the excess deficiency.

Long-duration contracts A long-duration contract premium deficiency exists if the insurer's actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses indicates that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient to:

- Cover the present value (PV) of future benefits to be paid to or on behalf of policyholders as well as settlement and maintenance relating to long-duration contracts.
- Recoup any unamortized acquisition costs.

Based on the aforementioned, SFAS 60 requires that a premium deficiency should be computed as follows:

PV of future payments for benefits and related settlements and maintenance costs, determined by using revised assumptions based on actual and anticipated experience	\$XXXX
Less: PV of future gross premiums, determined by using revised assumptions based on actual and anticipated experience	<u>XXXX</u>
Liability for future policy benefits using revised assumptions	\$XXXX
Less: Liability for future policy benefits at the valuation date, reduced by unamortized acquisition costs	<u>XXXX</u>
Premium deficiency	<u><u>\$XXXX</u></u>

The premium deficiency should be recorded by a charge to income and (1) a reduction of unamortized costs or (2) an increase in the liability for future policy benefits.

If a premium deficiency does occur, future changes in the liability should be based on the insurer's revised assumptions. In addition, no loss should be recognized if it ultimately results in creating future income.

Replacement Transactions

Universal-life-type contracts are often purchased as replacements for other insurance contracts issued by the same insurer. A policyholder commonly uses the cash surrender value of the previous contract to pay an initial lump sum premium for the new replacement contract. When a replacement occurs with a universal-life-type contract, any unamortized acquisition costs associated with the replaced contract and any difference between the cash surrender value and its previously recorded liability should not be deferred in connection with the replacement.

Accounting for Policyholder Dividends

Policyholder dividends are paid on participating insurance contracts of life insurance enterprises. These contracts allow the policyholder to participate in the earnings or surplus of the insurance entity. SFAS 60 requires that policyholder dividends be accrued using an estimate of the amount that will be paid. Two situations prevail here:

1. For life insurance companies that use life insurance dividend scales unrelated to actual net income earned, policyholder dividends should be accrued over the premium paying periods of the contract.
2. If limitations exist on the amount of net income from participating insurance contracts that may be distributed to stockholders, the amount of the policyholder's share of net income that cannot be distributed to stockholders should be excluded from stockholders' equity by a charge to current operations and a credit to a liability relating to participating policyholders' funds. Dividends declared or paid to participating policyholders should then reduce this liability. Any dividends declared or paid in excess of the liability should be charged to current operations.

Contingent Commission Arrangements

Experience-rated insurance contracts sometimes provide that an insurance agent should be paid additional commissions under an experience refund arrangement. For example, if a particular policy that an insurance agent sold has had a positive experience in a given period, that agent is due additional commission. Income in any period should not include amounts that are expected to be paid to agents in the form of experience refunds or additional commissions. Instead, contingent commissions payables or receivables should be accrued over the period in which related income is recognized.

Accounting for Insurance Entity Investments

An insurance enterprise should account for its investments in debt and equity securities that have readily determinable fair values in accordance with SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*.

Investments that are not addressed by SFAS 115 because they do not have a readily determinable fair value should also be reported at fair value, with changes in such values accounted for as unrealized gains and losses and reported net of taxes in other comprehensive income. However, all or a portion of the unrealized gain or loss of a security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge.

Mortgage loans should be reported at their outstanding principal balance if acquired at par value. When purchased at a discount or premium, they should be reported at amortized cost with an allowance for estimated uncollectible amounts. Amortization of the discount or premium and related charges or credits is charged or credited to investment income.

Investments in assets in which the holder would not recover substantially its recorded investment (e.g., interest-only strips, loans, other receivables, retained interests in securitizations) should be classified as investments in debt securities and reported in the available-for-sale or trading portfolio.

Real estate investments should be reported at their cost less any accumulated depreciation. Depreciation and related charges or credits should be charged or credited to investment income.

Real Estate Used in the Business

Real estate acquired by an insurance enterprise is classified in one of two ways: as an investment or as real estate that is being used in the entity's operations. Thus, depreciation and other real estate operating expenses should be classified either as investment expenses or as operating expenses, depending how the real estate is categorized.

When Are Separate Accounts Used by an Insurance Entity?

Insurance entities frequently maintain separate assets and liabilities accounts for a contract holder for purposes of funding fixed-benefit plans, pension plans, and variable annuity contracts. The insurance enterprise, in this circumstance, receives a fee for investment management, administrative expenses, and other related functions. It is the contract holder, however, who assumes the investment risk, as it is he or she who directs the portfolio management.

Investments in the separate accounts described previously should be reported at market value except for those with guaranteed investment returns. For those separate accounts, the related assets should be reported as investments of the insurance enterprise described in the investments section previously noted. In addition, the assets and liabilities of separate accounts should be reported as summary totals in the insurance entity's financial statements.

Income Tax Considerations

Insurance enterprises are required to recognize a deferred tax liability or asset for the deferred tax consequences of temporary differences necessitated by SFAS 109. However,

an insurance entity should not recognize deferred taxes on taxable temporary differences related to policyholder's surplus that arose in fiscal years beginning December 15, 1992. If, on the other hand, there is an expected reduction in policyholders' surplus, and it is likely that the insurance entity will pay income taxes either currently or in subsequent years, the income tax expense attributable to this reduction should be accrued and recognized in the current period.

Reinsurance

Insurance entities frequently seek to obtain indemnification against loss or liability from liability from claims associated with contracts they wrote. They do this by entering into a reinsurance contract with another insurance entity called the reinsurer or assuming entity. When such a contract is consummated, the original insurer, known as the ceding enterprise, pays an amount to the reinsurer and the latter agrees to reimburse the insurer for a specified portion of the claims paid under the reinsurance contract. The legal rights of the insured remain unaffected by the reinsurance transaction. Although the insurer is indemnified for contracted losses under this arrangement, it is not relieved of obligation to the original policyholder, who, incidentally, is usually unaware of the reinsurance arrangement. In addition, the reinsurer may enter into reinsurance contracts with other reinsurers to be indemnified for loss and liability in a process known as retrocession.

Indemnification against Loss or Liability Relating to Insurance Risk through Reinsurance Contracts

Ascertaining whether a reinsurer's insurance contract with a ceding enterprise provides indemnification against loss or liability relating to insurance risk requires an understanding of the arrangement between the parties involved.

Short-duration contracts In a short-duration contract, the reinsurer is required to assume significant insurance risk under the reinsured portions of the underlying insurance contracts. In this situation, it is assumed that both the timing and amount of the reinsurer's payments will depend on and vary directly with the amounts and timing of claims settled under the reinsured contract. Provisions in the reinsurance contract that delay timely reimbursement to the ceding entity would prevent the assumption of significant risk by the reinsurer. Contractual features may also prevent the reinsurer's payments from directly varying with the claims settled under the reinsured contract.

There must be a reasonable possibility (more than remote and less than probable) that the reinsurer may realize a significant loss from the transaction. To determinate whether a loss is reasonably possible, the present value of all cash flows between the ceding and assuming entities under reasonable possible outcomes are compared with the present value of amounts paid or deemed to have been paid to the reinsurer. If this comparison indicates that the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity may be considered indemnified against loss only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer.

Long-duration contracts There must be a reasonable possibility that the reinsurer will realize a significant loss from indemnifying a ceding insurance entity against loss or liability in assuming the insurance risk in a reinsurance contract. Long-duration contracts that do not subject the insurance enterprise to mortality or morbidity risks should be classified as investment contracts rather than insurance contracts.

Reinsurance Transactions

Reinsurance contracts that are legal replacements of one insurer by another eradicate the ceding entity's liability to the policyholder and result in the removal of related assets and liabilities from that entity's financial statements. Some reinsurance contracts do not extinguish the ceding entity's legal liability to the policyholder. In this situation, the ceding entity should not remove the related assets and liabilities from its financial statements.

Estimated reinsurance receivables arising from those contracts with enterprises that reinsure insurers should be reported separately as assets. In addition, amounts prepaid to the reinsurer relating to reinsurance contracts should also be reported as assets.

Receivables and payables between a reinsurer and the ceded entity should be offset only when a right of set-off exists. Earned premiums ceded (paid to the reinsurer) and recoveries recognized under reinsurance contracts should be reported in either the statement of earnings or the footnotes to the financial statements.

Recognition of Revenues and Costs for Reinsurance Contracts

The parameters for revenue and cost recognition relating to reinsurance by the insurer depend on whether the contract is in fact a bona fide reinsurance contract (see section on indemnification against loss or liability relating to insurance risk). Recognition also depends on whether the contract is of a short or long duration.

Contracts That Do Not Meet the Conditions for Reinsurance Accounting

If, despite its form, the reinsurance contract does not provide for indemnification of the ceding entity against loss and liabilities, the premiums paid less the premium that is to be retained by the reinsurer should be accounted for as a deposit by the ceding entity. A net credit that results from the contract is reported as a liability by the ceding entity. A net charge resulting from the contract, on the other hand, should be reported as an asset by the reinsurer.

In addition, proceeds from reinsurance transactions that represent recovery of acquisition costs should reduce unamortized acquisition costs so that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized. If the ceded entity has agreed to service all related insurance contracts without reasonable compensation, a liability should be accrued for estimated excess servicing costs under the reinsurance contract. Any net cost should be accounted for as an acquisition cost.

Contracts That Meet the Conditions for Reinsurance Accounting

Short-duration contracts Amounts paid for prospective reinsurance by the ceded enterprise should be accounted for and reported as prepaid insurance premiums and amortized over the remaining contract period in proportion to the amount of insurance protection provided.

If the amounts paid in are subject to adjustment, the basis for amortization should be the amount that is estimated to be paid.

Amounts that are paid for retroactive reinsurance should be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities, in fact, exceed the amounts paid, the reinsurance receivables should be increased to reflect the difference and the resulting gain that is deferred. This gain is then amortized over the estimated remaining settlement period. (The settlement period is the estimated period over which the ceding entity expects to recover amounts from the reinsurer under the terms of the reinsurance contract.) If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the gain should be amortized using the interest method. The recovery method is used when amounts and timing of recoveries cannot be estimated. The recovery method bases the amount of amortization on the proportion of actual recoveries to the total estimated recoveries. If the amount that was paid for retroactive reinsurance exceeds the recorded liabilities relating to the reinsured contracts, the ceding entity should increase the related liabilities, reduce the reinsurance receivable, or do both at the time the reinsurance contract has been effected so that the excess is charged to earnings.

The amortization of deferred amounts (under both the interest method and recovery method) should be based on estimates of the ceding entity's estimates of the expected timing and amounts of cash flows. The timing of changes in these estimates should not change the recognition of revenues and reinsurance costs.

SFAS 113 requires that any changes in estimates relating to the amount that will be recovered from the insurer be accounted for consistently at both the beginning of and after the reinsurance transactions. Changes in the estimated amount of liabilities relating to the underlying insurance contracts should be recognized in income in the period of the change. Reinsurance receivables must reflect any adjustment in the amount recoverable from the reinsurer, and a gain should be adjusted or established.

Reinsurance contracts include both prospective and retroactive provisions. For example, a given reinsurance contract may insure liabilities relating to contracts applying to one or more prior years and may at the same time insure losses under contracts covering one or more future periods. When possible, prospective and retroactive provisions should be accounted for separately. If separate accounting within a single contract is impracticable, the contract should be accounted for as a retroactive contract.

Long-duration contracts The insurance enterprise should amortize the estimated cost of reinsurance of long-duration contracts over the remaining life of the underlying reinsured contracts. This compares to the cost of reinsurance of short-duration contracts where the cost is amortized over the reinsurance contract period. Determining whether an insurance contract that reinsures a long-duration contract is long or short duration is a matter of professional judgment. Nevertheless, the assumptions relating to accounting for reinsurance costs should be consistent with those used for the reinsured contract. Any difference between the amount paid for a reinsurance contract and the amount of liabilities

for policy benefits relating to the underlying reinsured contract is part of the estimated cost to be amortized.

Disclosure Requirements

GAAP requires that insurance entities disclose the following information in their financial statements:

1. The basis for estimating liabilities for unpaid claims and claim adjustment expenses.
2. The methods and assumptions used in estimating the liability for future policy benefits. This should include the disclosure of the average rate of assumed investment yields in effect for the current year.
3. The nature of acquisition costs that were capitalized. In addition, the method of amortizing those costs and the amount that was amortized for the period should be shown.
4. The carrying amount of liabilities for unpaid claims and claim adjustment expenses on short-duration contracts. These should be presented at their present value in the financial statements with the range of interest rates that were used to discount those liabilities.
5. Determination of whether the insurance entity considered anticipated investment income in determining whether a short-duration contract premium deficiency exists.
6. The relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income that was allocated to participating policyholders.
7. The amount of statutory capital and surplus.
8. The amount of statutory capital and surplus needed to satisfy regulatory requirements based on current operations if material in relation to the entity's statutory capital and surplus.
9. The nature of statutory restrictions on the payment of dividends and the amount of retained earnings that are not available for payment to stockholders.
10. The nature, purpose, and effect of any ceded reinsurance transactions on the insurance entity's operations. In addition, the ceded enterprise must disclose the fact that it is not relieved of its primary obligation to the policyholder in a given reinsurance transaction.
11. For short-duration contracts, premiums from direct business; reinsurance assumed; and reinsurance ceded on both a written and earned basis.
12. For long-duration contracts, premiums and amounts assessed against policyholders from direct business; reinsurance assumed and ceded; and premiums and amounts earned.
13. Methods used for income recognition on reinsurance contracts.

Ceding insurance entities are required to disclose concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums.

CHAPTER 12 INVESTMENT INDUSTRY

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Explain how to report investment securities at fair value.
- Outline Internal Revenue Code regulations relating to investment companies.
- List the conditions under which from the statement of cash flows is exempt.

TERMINOLOGY

Closed-end fund. An investment company having a fixed number of shares outstanding, which it does not stand ready to redeem. Its shares are traded similarly to those of other public corporations.

Closed-up fund. An open-ended investment company that no longer offers its shares for sale to the general public but still stands ready to redeem its outstanding shares.

Equalization. An accounting method used to prevent a dilution of the continuing shareholders' per share equity in undistributed net investment income caused by the continuous sales and redemptions of capital shares.

Ex-dividend or ex-distribution. Synonym for shares being traded without dividend or without capital gains distribution.

Open-end investment company. A mutual fund that sells its shares to the public on an ongoing basis and is always willing to buy back its shares from investors who tender them for redemption.

SOURCES OF GAAP

The key source of authoritative GAAP relating to guidance in the Investment Industry is:

- SFAS 102 (*Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*)

RULES, CONCEPTS, AND ILLUSTRATIONS

An investment company aggregates shareholders' funds to provide shareholders with overall professional management expertise. Investment companies provide their shareholders with the following functions: selling shares, investing share proceeds in investment securities, and distributing net income and net realized gains to shareholders.

Liquid investment companies that meet certain criteria are exempt from the general GAAP requirement that a statement of cash flows be provided as part of a full set of financial statements.

KEY GAAP

Investment companies should report all of their investment securities at market value or fair value determined by management if market value is unavailable. Investment companies are exempt from SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, and as such have their own guidelines regarding securities disclosures.

Purchases and sales of investment securities should be at cost and recorded in the accounting records of the investment company at the trade date. This allows the company to include all securities purchased or exclude all securities sold in (from) its financial statement as of the balance sheet date. In addition, dividend income should be accounted for on the ex-dividend date rather than the date of payment so that the market prices of the securities on which the dividend was declared will not be affected by the dividend. Because mutual fund shares are purchased and redeemed at net asset value, it is necessary for the investment company to record its dividends payable liabilities on the ex-dividend date. As would be expected, if an individual purchases mutual fund shares between the date of declaration of the dividend and the ex-dividend date, the investor is entitled to receive the dividends. On the other hand, if shares are purchased after the ex-dividend date, then the acquirer is not entitled to receive them.

An open-end investment company is one that sells its shares to the public on an ongoing basis and is always willing to buy back its shares from investors who tender them for redemption. In accounting for an open-end company, a method known as equalization is utilized. This process precludes dilution of shareholders' per share equity in undistributed net investment income that results from the ongoing sales and redemption of mutual fund shares. The investment company makes the assumption that the net asset value of each share sold or redeemed is made up of the par value of the stock, additional paid-in-capital, any undistributed income, and any retained earnings that exist. As shares are bought and sold, the investment company continually determines the magnitude of undistributed earnings that are available for its shareholders to receive. Based on the number of shares that are outstanding, this amount is added to an equalization account when the shares are sold and subtracted when the shares are redeemed.

Under current Internal Revenue Code regulations, investment companies do not have to account for federal income taxes on their taxable income or taxable realized gains resulting from its investments. This occurs as a result of the requirement that an investment company must distribute all of its taxable income and taxable realized gains to its shareholders. Thus, for tax purposes the investment entity acts as a conduit or funnel with respect to its shareholders. If, on the other hand, all taxable income and taxable realized gains for a given tax period are not distributed, then the investment company must record a tax liability at the end of the last day of tax period. Thus, in this situation, shareholders of the investment company are entitled to a credit for taxes paid.

Exemption Form Statement of Cash Flow Requirement

SFAS 102 provides that an investment company is exempt from including a statement of cash flows as part of its required financial statements if the following conditions are met:

1. The company's investments are all highly liquid.
2. The company includes a statement of changes in net assets with its financial statements.
3. The company had an immaterial amount of debt relative to its average total assets based on its average debt outstanding during the accounting period.
4. The company's investments were carried at market value in the accounting records and financial statements.

CHAPTER 13

MORTGAGE BANKING INDUSTRY

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Outline activities of mortgage banking industry.
- Apply the lower of cost or market rule to mortgage loans.
- Differentiate between mortgage loans held for sale versus mortgage loans held as long-term investment.

TERMINOLOGY

Affiliated enterprise. An enterprise that directly or indirectly controls, is controlled by, or is under common control with another enterprise; also, a party with which the enterprise may deal if one party has the ability to exercise significant influence over the other's operating and financial policies.

Current (normal) servicing fee rate. A servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of mortgage loans.

Federal Home Loan Mortgage Corporation (FHLMC). Often referred to as "Freddie Mac," a private corporation authorized by Congress to assist in the development and maintenance of a secondary market in conventional residential mortgages. FHLMC purchases mortgage loans and sells mortgages principally through mortgage participation certificates (PCs) representing an undivided interest in a group of conventional mortgages. FHLMC guarantees the timely payment of interest and the collection of principal on the PCs.

Federal National Mortgage Association (FNMA). Often referred to as "Fannie Mae," an investor-owned corporation established by Congress to support the secondary mortgage loan market by purchasing mortgage loans when other investor funds are limited and selling mortgage loans when other investor funds are available.

Gap commitment. A commitment to provide interim financing while the borrower is in the process of satisfying provisions of a permanent loan agreement, such as obtaining a designated occupancy level on an apartment project. The interim loan ordinarily finances the difference between the floor loan (the portion of a mortgage loan commitment that is less than the full amount of the commitment) and the maximum permanent loan.

Government National Mortgage Association (GNMA). Often referred to as "Ginnie Mae," a U.S. governmental agency that guarantees certain types of securities (mortgage-backed securities) and provides funds for and administers certain types of low-income housing assistance programs.

Internal reserve method. A method for making payments to investors for collections of principal and interest on mortgage loans by issuers of GNMA securities. An issuer electing the internal reserve method is required to deposit in a custodial account an amount equal to one month's interest on the mortgage loans that collateralize the GNMA security issued.

Mortgage-backed securities. Securities issued by a governmental agency or corporation (for example, GNMA or FHLMC) or by private issuers (for example, FNMA, banks, and mortgage banking enterprises). Mortgage-backed securities generally are referred to as *mortgage participation certificates* or *pass-through certificates* (PC5). A PC represents an undivided interest in a pool of specific mortgage loans. Periodic payments on GNMA PCs are backed by the U.S. government. Periodic payments on FHLMC and FNMA PCs are guaranteed by those corporations, but are not backed by the U.S. government.

Mortgage banking enterprise. An enterprise that is engaged primarily in originating, marketing, and servicing real estate mortgage loans for other than its own account. Mortgage banking enterprises, as local representatives of institutional lenders, act as correspondents between lenders and borrowers.

Permanent investor. An enterprise that invests in mortgage loans for its own account, for example, an insurance enterprise, commercial or mutual savings bank, savings and loan association, pension plan, real estate investment trust, or FNMA.

Servicing. Mortgage loan servicing includes collecting monthly mortgagor payments, forwarding payments and related accounting reports to investors, collecting escrow deposits for the payment of mortgagor property taxes and insurance, and paying taxes and insurance from escrow funds when due.

Standby commitment. A commitment to lend money with the understanding that the loan probably will not be made unless permanent financing cannot be obtained from another source. Standby commitments ordinarily are used to enable the borrower to obtain construction financing on the assumption that permanent financing will be available on more favorable terms when construction is completed. Standby commitments normally provide for an interest rate substantially above the market rate in effect when the commitment is issued.

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in the mortgage banking industry are:

- SFAS 65 (*Accounting for Certain Mortgage Banking Activities*).
- SFAS 91 (*Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*).
- SFAS 115 (*Accounting for Certain Investments in Debt and Equity*).

Securities).

- SFAS 124 (*Accounting for Certain Investments Held by Not-for-Profit Organizations*).
- SFAS 133 (*Accounting for Derivative and Hedging Activities*).
- SFAS 134 (*Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loan Held for Sale by a Mortgage Banking Enterprise—an Amendment of SFAS 65*).
- SFAS 140 (*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*).
- FASB Technical Bulletin No. 87–3 (*Accounting for Mortgage Servicing Fees and Rights*).

RULES, CONCEPTS, AND ILLUSTRATIONS

Mortgage banking consists of the purchase or origination of mortgage loans and sale of the loans to such investors as insurance companies, commercial savings banks, pension plans, real estate investment trusts, etc. (These investors, known as permanent investors, invest in mortgage loans for their own account.) In addition, mortgage banking entities also retain the right to service mortgage loans that they sell to investors. A servicing fee is received for this function.

In general, mortgage loans that are held for sale should be disclosed at the lower of cost or market value. In addition, any direct loan origination costs and origination fees for loans held for sale should be capitalized as part of the carrying amount of the related loan. These costs should not be amortized.

If loans are held for investments, any direct loan origination costs and origination fees should be deferred and recognized as an adjustment to yield. If there are also loan commitment fees, these should be deferred and recognized over the life of loan or until the loan is sold. In general, any fees that are paid to permanent investors should be recorded as expenses when the loans are sold. In addition, any fees for services performed by a third party and loan placement fees should be recognized when all the major services have been performed.

KEY GAAP

Mortgage Loans and Mortgage-Backed Securities

GAAP requires that mortgage loans held for sale should be disclosed at the lower of cost or market value. In the case of a fair value hedge in which a mortgage loan is the hedged item, the cost of the loan (for the purpose of disclosing the lower of cost or market) should be adjusted in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS 133 requires that the amount of the hedged item be adjusted for the change in its fair value (gain or loss) attributable to the hedged risk. It also requires that the gain or loss be recognized in earnings and be accounted for using a valuation allowance. Thus, changes in the valuation allowance from period to period should be included in net income in the period of the change.

SFAS 65 prohibits purchase discounts on mortgage loans from being amortized as interest revenue in the period in which the loans are being held for sale. SFAS 65 requires that a mortgage loan not be classified as a long-term investment unless the mortgage banking entity has the ability and intent to hold the loan until maturity. In accounting for the transference to long-term status, the mortgage loan should be accounted for at the lower of cost or market value on the transfer date. Any difference that exists between the carrying amount of the loan and its outstanding principal balance should be recorded as an adjustment to yield by the interest method. If a mortgage loan held for sale is securitized, any retained mortgage-backed securities should be classified in accordance with SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. SFAS 134 notes that if a mortgage banking entity commits to sell any retained mortgage-backed securities before or during the securitization process, it must classify such securities as trading.

If a mortgage loan that is held for sale as a long-term investment is deemed impaired (beyond temporary status), the carrying amount of the loan should be reduced to the amount that the entity expects to receive. A loss should be recorded and the amount expected to be collected should become the security's new cost basis. A gain on recovery should not be recorded. However, upon maturity, sale, or other disposition of the security, a gain may be recognized and reported.

Ascertaining the market value of mortgage loans and mortgage-backed securities held for sale is a function of loan type. For example, separate market determinations should be made for residential and commercial mortgage loans. In addition, for each type of loan, the lower of cost or market value should be determined using either the aggregate or individual loan basis.

The market value of uncommitted loans (loans held on a speculative basis), uncommitted mortgage-backed securities, and committed loans (loans subject to investor purchase commitments) should be determined separately using the following parameters:

- *Uncommitted loans.* Market value is based on the market in which the mortgage banking entity regularly operates. Determination of market value should consider:
 - The market prices and yields determined by the entity's normal operating outlets.
 - Security prices from the Government National Mortgage Association (GNMA) or other long-term mortgage rates from other public market quotations.
 - Current delivery prices of the Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA).
- *Uncommitted mortgage-backed securities.* Uncommitted mortgage backed securities that are collateralized by a mortgage banking entity's own loans should be based on the market value of the securities. If the trust that holds these loans may be terminated and the loans sold directly, fair value of the securities should be based on the market value of the loans or securities. Other

mortgage-backed securities should be based on the yields of published mortgage-backed securities.

- *Committed loans and mortgage-backed securities.* The market value of these securities (mortgage loans that are covered by investor commitments) should be based on fair value.

In general, capitalized costs of acquiring rights to service mortgage loans associated with the purchase or origination of mortgage loans should be excluded from the cost of mortgage loans for the purpose of determining lower of cost or market value.

Loan and Commitment Fees

Mortgage banks may receive or pay nonrefundable loan or commitment fees representing various sources of compensation. These fees may include, for example, an adjustment of the interest yield on the loan, a fee for designating funds for the borrower, or an offset of loan origination costs. Loan and commitment fees should be accounted for in the following manner:

- *Loan origination fees and costs.* If the loan is held for resale, loan origination costs should be deferred until the related loan is sold. If the loan is held for investment, such fees and costs should be deferred and recognized as an adjustment of yield.
- *Services fees.* Fees for the reimbursement for the costs of specific services performed by third parties with respect to originating a loan, such as appraisal fees, should be recognized as revenue when the services have been performed.
- *Fees relating to loans held for sale.* In general, fees received for guaranteeing the funding of mortgage loans to borrowers, builders, or developers should be deferred and recognized over the life of the loan as an adjustment of yield. Fees paid to permanent investors to ensure the sale of loans (residential or commercial loan commitment fees) should be recognized as expense when the loans are sold to permanent investors or when it appears that the commitment will not be used. In general, residential loan commitment fees relate to blocks of loans; therefore, fees recognized as revenue or expense as a result of individual loans transactions should be based on the ratio of the individual loan amount to the total commitment amount.

Loan placement fees—that is, fees generated for arranging a commitment directly between a permanent investor and a borrower—should be recognized as revenue when all significant services have been performed. In another situation, if a mortgage banking entity obtains a commitment from a permanent investor before or at the time a related commitment is made to a borrower and if the commitment to the borrower requires that the following conditions occur, then the related fees should also be accounted for as loan

placement fees. The two conditions that must be satisfied are:

- Simultaneous assignment of the commitment to the investor.
 - Simultaneous transfer to the borrower of the amount received from the investor.
-
- *Fees relating to investment loans (loans not held for sale).* Fees relating to the origination or acquisition of loans for investment should be deferred and recognized as an adjustment of yield.
 - *Loans repaid before repayment date or commitment expiration.* If a loan is paid before its repayment date or if a loan commitment expires without a loan occurring, then any related fees that have not been recognized should be recognized as revenue or expense at the time of that occurrence.

Balance Sheet Classification and Disclosures

Mortgage banks' balance sheet presentation must distinguish between (1) mortgage loans held for sale and (2) mortgage loans held as long-term investments.

The method that the mortgage bank entity used in determining the lower of cost or market value of mortgage loans (either in the aggregate or on an individual loans basis) should be disclosed.

CHAPTER 14

MOTION PICTURE INDUSTRY

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Explain the five conditions that must be met before recognizing revenue from the sale or licensing arrangement of a film
- Account for the costs of producing a film, including participation costs, exploitation costs, and manufacturing costs

TERMINOLOGY

Distributor (film distributor). Owner of the rights to distribute films, which are sold (licensed) to movie theaters, individual television stations, groups of stations, networks, or others. This definition excludes syndicators or other independent sales organizations that act only as sales agents for producers or owners of films under agreements that do not call for the sharing of profits.

Exploitation costs. Costs incurred during the final production phase and during the release periods of films in both primary and secondary markets. Examples of such costs are film prints, advertising, rents, salaries, and other distribution expenses.

Home viewing market. All means by which films are sold or otherwise made available to residential viewers for a fee. Examples are video cassettes and disks and all forms of pay television, including cable and over-the-air transmission.

Independent producer. Motion picture companies frequently advance funds or guarantee loans for the production of films by independent producers. Certain legal rights of ownership, including the copyright, may be retained by the independent producer. The motion picture company frequently has a participation in the net revenues from the film and generally has additional attributes of ownership, such as the right to exploit the film and the risk of loss. The financing arrangement usually provides that the production loan by the motion picture company (or the guaranteed loan) is repayable only from the revenues from the particular film. The independent producer does not have general liability with respect to such a loan. Consequently, the motion picture company bears substantially all the risks of ownership.

License agreement for television program material. A typical license agreement for television program material covers several films (a package) and grants a broadcaster (licensee) the right to telecast either a specified number or an unlimited number of showings over a maximum period of time (license period) for a specified fee. Ordinarily, the fee is paid in installments over a period generally shorter than the license period. The agreement usually contains a separate license for each film in the package. The license expires at the earlier of the last allowed telecast or the end of the license period. The

licensee pays the required fee whether or not the rights are exercised. If the licensee does not exercise the contractual rights, the rights revert to the licensor with no refund to the licensee. The license period generally is not intended to provide continued use of the film throughout that period but rather to define a reasonable period of time within which the licensee can exercise the limited rights to use the film.

Market. The first market in which a film is exploited is called the primary market because that is the market for which a film principally is produced. All other exploitation is in the secondary market. Generally, the markets are mutually exclusive; that is, a film cannot be exploited in more than one market at a time because of the contract terms or sound marketing techniques. There is only one first-run telecast of a particular film in a given market, and film rights are marketed in a manner to avoid conflict in a given market. For example, conflict may exist in a market between (a) theaters and television stations, (b) premium cable or broadcast subscription television and network television, (c) network television and local stations, and (d) two or more local stations within the market area. To avoid conflict between theaters and television, a producer may impose restrictions on distribution that would prohibit the licensing of the film for television while the film is being shown in movie theaters. The market in which a film is exhibited is a prime determinant of the value of the film. A film's previous exposure in a market will generally have an effect on the price the exhibitor is willing to pay for exhibition rights. In addition, the size and demographics of a particular market and the audience's acceptance of the film affect the price that a telecaster can charge for advertising time.

Motion picture film. All types of films and video cassettes and disks, including features, television specials, series, and cartoons that are (a) exhibited in theaters; (b) licensed for exhibition by individual television stations, groups of stations, networks, cable television systems, or other means; or (c) licensed for the home viewing market.

Net realizable value. Net realizable value is the estimated selling price (rental value) in the ordinary course of business less estimated costs to complete and exploit in a manner consistent with realization of that income.

Participation. Frequently, persons involved in the production of a motion picture film are compensated, in part or in full, with a participation in the income from the film. Determination of the amount of compensation payable to the participant is usually based on percentages of revenues or profits from the film from some or all sources. Television residuals are comparable to participations and are generally based on the number of times the film is exhibited on television or as a percentage of revenues from such exhibition.

Producer. An individual or motion picture enterprise that produces films for exhibition in movie theaters, on television, or elsewhere.

Production costs. The cost of a story and scenario to be used for a film and other costs to produce a film, for example, salaries of cast, directors, producers, extras, and miscellaneous staff; cost of set construction and operations, wardrobe, and all accessories; cost of sound synchronization; production overhead, including depreciation and

amortization of studio equipment and leasehold improvements used in production; and rental of facilities on location. Production costs ordinarily are accumulated by individual films in four chronological steps: (a) acquisition of the story rights; (b) preproduction, which includes script development, costume design, and set design and construction; (c) principal photography, which includes shooting the film; and (d) postproduction, which includes sound synchronization and editing, culminating in a completed master negative.

SOURCES OF GAAP

The key source of authoritative GAAP relating to guidance in the motion picture industry is:

- SFAS 139 (*Rescission of SFAS 53 and Amendment to SFAS 63, 89, and 121*).

An entity that was subject to SFAS 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, must now follow the guidance of AICPA Statement of Position (SOP) No. 00-2.

RULES, CONCEPTS, AND ILLUSTRATIONS

An entity should recognize revenue from a sale or licensing arrangement of a film when five conditions are met. If a licensing arrangement of a single film provides that an entity will receive a flat fee, the entity should recognize this fee as revenue only when it has met all five criteria. The costs of producing a film and bringing that film to market consists of film costs, participation costs, and manufacturing costs. An entity should report its film costs as a separate asset on its balance sheet. An entity should amortize film costs and accrue participation costs using the individual-film-forecast-computation method, which amortizes or accrues (expenses) in the same ratio that current period actual revenue (numerator) bears to estimated remaining unrecognized ultimate revenue as of the beginning of the current fiscal year (denominator). An entity should account for advertising costs in accordance with SOP 93-7, *Reporting on Advertising Costs*. All other exploitation costs, including marketing costs, should be expensed when incurred. An entity should charge manufacturing costs and duplication costs of products for sale, such as videocassettes and digital video discs, to expense on a unit specific basis when the related product revenue is recognized.

KEY GAAP: ACCOUNTING BY PRODUCERS OR DISTRIBUTORS OF FILMS

Revenue Recognition-Basic Principles

An entity may license films to such customers as distributors, theaters, exhibitors, or other licensees on either an exclusive or nonexclusive basis in a particular market and territory. The license fee may be fixed (flat fee) or based on a percentage of a customer's revenue (variable fee). A variable-fee arrangement may include a nonrefundable guarantee that may be paid in advance or over a license period.

Revenue from a sale or licensing arrangement of a film should be recognized when all of the following conditions are met:

- Persuasive evidence exists of a sale or licensing arrangement with a customer.
- The film is complete and has been delivered or is available for immediate and unconditional delivery (in accordance with the terms of the arrangement).
- The license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale.
- The fee that has been arranged for is fixed or determinable.
- Collection of the fee is reasonably assured.

If one or more of the preceding conditions are not met, the entity should defer recognizing revenue until all of the conditions are met.

If a receivable is recognized on the accounting records of an entity for advances presently due or cash payments are received prior to revenue recognition, the entity should also recognize an equivalent liability for deferred revenue until the entity satisfies all five conditions of revenue recognition. If that receivable is transferred to a third party, the liability for deferred revenue should not be reduced and the revenue for the film should not be recognized until all conditions of revenue recognition are met. Discussion of Revenue Recognition Considerations Persuasive evidence of an arrangement Persuasive evidence of an arrangement

Discussion of Revenue Recognition Considerations

Persuasive evidence of an arrangement Persuasive evidence of an arrangement is generally provided only by a contract or other enforceable document that indicates the license period that is applicable, the film or films that are affected, the rights transferred, and the consideration that will be exchanged. If these factors somehow raise doubt regarding the obligation or ability of either party to perform under the terms of the arrangement, revenue should not be recognized by the entity. Based on the aforementioned, forms of verifiable evidence (e.g., a written contract, purchase order, or online authorization) to document the contract arrangements should be presented. This evidence should clearly show that there is in fact a mutual agreement between the entity and the customer or that actions by the customer are in accordance with such an agreement.

Delivery Revenue recognition should not occur until the product is delivered, assuming the licensing agreement requires such an agreement. If no such requirement exists, it is assumed that physical delivery is required in order to recognize revenue. Some licensing agreements do not require the delivery of the film to the customer. If the arrangement gives the customer immediate and unconditional access to the film print or authorization to make the film immediately and unconditionally available for the customer's use, the delivery condition for revenue recognition is considered met. If the licensing agreement requires that the entity make significant changes to a film after its initial availability to a customer, the delivery condition is not deemed to be met. Revenue should not be recognized until these significant changes are met as well as the other conditions for revenue recognition previously discussed. Significant changes are additions of new or revised content to the film after it is initially available to the customer. Costs for reshooting a scene or adding special effects, for example, should be added to the film costs and charged to expense when the entity recognizes the related revenue. Insignificant

changes consist of insertions or additions of preexisting film footage, additions of dubbing or subtitles (done to existing footage), removal of offensive language, reformatting a film, and adjustments to allow for the insertions of commercials. These changes do not preclude the recognition of revenue by the entity prior to their completion and should be accrued and charged to expense if the entity begins to recognize revenue from the agreement before incurring those costs.

Availability Some arrangements in a given contract will restrict a customer from initiating its exploitation, exhibition, or sale of given film. For example, a contract may restrict a customer from selling or displaying a given home video product until months in the future, or a film may be restricted from exploitation, exhibition, or sale in a given territory or market for a period of time. In these situations, revenue should not be recognized until the restrictions lapse or expire and the conditions of revenue recognition previously noted are satisfied.

Fixed or determinable fee If a single film arrangement provides that an entity will receive a flat fee, that entire fee (considered fixed and determinable) should be recognized revenue when the entity has met all of the other revenue recognition conditions. In a multiple-films arrangement (including films not yet produced or completed), the entity should allocate the fixed or determinable fee to each individual film by market or territory, based on relative fair values of the rights to exploit each film under the licensing agreement. Allocations to a film or films not yet produced or completed should be based on the amounts refundable if the entity does not ultimately complete and deliver the films to the customer. The remaining flat fee is allocated to the completed films based on their relative fair values of the rights to exploit them. Once an allocation is made, it should not be adjusted later. If relative fair values of films exploitation in a licensing arrangement cannot be ascertained, the fee is not fixed or determinable and the entity should not recognize revenue until such a determination can be made and all other conditions of revenue recognition are met. In determining the fair value of the rights to exploit an individual film that is part of a multiple-film arrangement, an entity must use the best information available in the circumstances with the objective of measuring the amount the entity believes it would have received had it entered into a license agreement that grants the same rights to the film separately rather than as a part of a multiple-film arrangement.

Variable fees If the entity's fee arrangement is predicated on a percentage or share of customer's revenue from the exhibition or other exploitation of a film, recognition of revenue should be based on meeting the conditions of revenue recognition previously noted as the customer exhibits or exploits the film.

Nonrefundable minimum guarantees In licensing arrangements that have a variable-fee structure, a customer may guarantee to pay an entity, a nonrefundable minimum amount, that is to be applied against the variable fee on a film or films that are not cross-collateralized. The nonrefundable minimum Guarantee should be considered fixed and determinable and should be recognized as revenue by the entity when all of the other conditions of revenue recognition are satisfied. If the nonrefundable minimum amount is applied against variable fees from a group of films on a cross-collateralized basis, the

amount of the minimum guarantee applicable to each film cannot be objectively determined. Revenue recognition during the license period should be recognized when the revenue recognition conditions previously noted are all satisfied. If at the end of the license period, a portion of the nonrefundable minimum guarantee remains unearned, an entity should recognize the remaining guarantee as revenue by allocating it to the individual films based on their relative performance.

Barter revenue If a licensing agreement to television stations provides programming in exchange for a specified amount of advertising on that station, the transaction is deemed a nonmonetary transaction. The accounting for this type of transaction should be in accordance with Accounting Principles Board (APB) No. 29, *Accounting for Nonmonetary Exchanges*, as interpreted by EITF No. 93-11, *Accounting for Barter Transactions Involving Barter Credits*.

Returns and price concession If the contract arrangement between the customer and the entity includes a right-of-return provision or the entity's past practices allow for such a procedure, then in order for the entity to recognize revenue, it must meet all the conditions of SFAS 48.

Revenue recognition when right of return exists For example, in the home video business, customers are frequently granted price protection on previously purchased and unsold products if the entity subsequently reduces its wholesale prices. At the date of revenue recognition, in this case, the entity is required to account for allowances given the possibility of price reduction. If future price concessions cannot be reasonably and reliably estimated (or there are some uncertainties regarding the entity's ability to maintain its prices), the revenue to be recognized is not considered fixed and determinable. The entity, in this situation, should not recognize revenue until it can make reasonable and reliable estimates of future price changes.

Licensing of film-related products An entity should recognize revenue from licensing arrangements of film-related products only after it releases the film itself.

Present value The amount of revenue recognized in connection with a licensing agreement should represent the present value of the licensing fee as of the date that the entity first recognizes the revenue (as required by APB 21, *Interest on Receivables and Payables*).

Costs and Expenses

By definition, the costs of producing a film and bringing that film to market consists of:

- Participation costs,
- Exploitation costs, and
- Manufacturing costs.

Discussion of Cost and Expenses Considerations

Capitalization of film costs Film costs include all direct costs incurred in the physical production of a film. They include expenditures such as the costs of story and scenario; film rights to books, stage plays, or original screenplays; compensation of cast, directors,

producers, and extras; costs of set construction, operations, and wardrobe; costs of sound synchronization; rental facilities on location; and postproduction costs (music, special effects, and editing). They also include allocations of production overhead and capitalized interest costs (accounted for in accordance with SFAS 34, *Capitalization of Interest Cost*). Production overhead consists of the costs of individuals or departments that have a significant (or exclusive) responsibility for the production of films. These costs should not include administrative and general expenses and the costs of certain “overall deals”. An entity may enter an arrangement called an overall deal, in which a producer or the like is compensated for his or her creative services. If the costs of overall deals cannot be associated with specific projects, they should be charged to expense as they are incurred over the related period of time. In general, an entity should record a reasonable proportion of costs of overall deals as specific project film costs to the extent that these costs are directly related to the acquisition, adaptation, or development of specific projects.

The cost of adaptation or development should also be added to the cost of a particular property. The entity should periodically review properties in development to see if they will be used in the production of a film. If it is determined that a property in development will be disposed of, the entity should recognize a loss on these costs by charging them to the current period income statement. The guideline to follow in these situations is that it is assumed that an entity will dispose of a property either by sale or abandonment if it has not been set for production within three years from the time of the first capitalized transaction. The amount of the loss is the amount by which the carrying amount of the project exceeds its carrying value. Amounts that have been written off should not recapitalized. The costs of producing a film and bringing it to market should be reported as a separate asset on the entity’s balance sheet.

Additional guidance for film costs is required for an episodic television series. Ultimate revenue for an episodic television series generally includes estimates from initial and secondary markets. The initial market is the first market of exploitation in each territory. That market may include a distribution channel, such as a broadcast or cable television network or first-run syndication. Secondary markets, by definition, are markets other than the initial market. Until an entity can establish estimates of secondary market revenue, the capitalized costs for each episode produced should not exceed the amount equal to the amount of revenue contracted for that episode. Any costs incurred in excess of this limitation on an episode-by-episode basis should be expensed as film costs incurred and not restored as capitalized film costs. As an entity recognizes the revenue for each television episode, the related capitalized costs of production (including the costs of sets) should be expensed. However, once the entity can estimate its secondary market revenue, it should capitalize all subsequent film costs. These capitalized expenditures, however, should be amortized and periodically evaluated for impairment.

Film costs amortization and participation costs accruals An entity is required to amortize film costs and accrue participation costs using the individual-film-forecast-computation method. The method amortizes or accrues film costs in the following ratio:

$$\frac{\text{Current period actual revenue}}{\text{Total estimated revenue}}$$

Estimated remaining unrecognized ultimate revenue* as of the beginning
of the current fiscal year

To calculate the amount of film costs that should be amortized for the period, the unamortized film costs as of the beginning of the current fiscal year are multiplied by the individual-film-forecast-computation method fraction. In addition, unaccrued ultimate participation costs that have to be recorded for the period are expensed by multiplying the individual-film-forecast-computation method fraction by the unaccrued ultimate participation costs at the beginning of the current fiscal year. Using this technique ensures that, in the absence of changes in estimates, film costs are amortized and participation costs are accrued in a manner that generates a constant rate of profit over the ultimate period for each period before exploitation costs (marketing, advertising, publicity, promotion, and other distribution expenses, manufacturing costs, and other period costs.) Participation costs are contingent payments paid to parties involved in the production of a film based on contractual formulas (participations) and by contingent amounts derived under the provisions of collective bargaining agreements (residuals).

Those that collect such amounts are called participants and these costs are collectively called participation costs. Participants generally include creative talent, such as actors, writers, or entities, from whom distribution rights are licensed. In general, an entity should accrue a liability for participation costs only if it is probable that there will be a sacrifice of assets to settle its obligation under the terms of a participation agreement.

**EXAMPLE: INDIVIDUAL-FILM-FORECAST METHOD
OF AMORTIZATION FOR A FILM IN ITS INITIAL
YEAR OF RELEASE**

Given: Film cost—\$62,500

Estimated ultimate revenue—\$125,000

Actual revenue earned in Year 1—\$75,000

Estimated ultimate participation costs—\$12,500

Film Cost Amortization in Year 1:

$$\frac{\$75,000 \text{ earned revenue}}{\$125,000 \text{ ultimate revenue}} \times \$62,500 \text{ film costs} = \$37,500$$

Participation costs accrued in Year 1:

$$\frac{\$75,000 \text{ earned revenue}}{\$125,000 \text{ ultimate revenue}} \times \$12,500 \text{ ultimate film costs}$$

$$= \$7,500$$

Actual results may very well vary from those that were estimated. Therefore, at each reporting date, the entity should review and revise

estimates of ultimate revenue and participation costs to reflect the most available information. If revisions take place, the entity should determine a new denominator that includes only the ultimate revenue from the beginning of the fiscal year of the change (the ultimate revenue changes are treated prospectively as of the beginning of the fiscal year of change). The numerator (revenue for the current fiscal year) is unaffected by the change. The entity should apply the revised fraction to the net carrying amount of unamortized film costs and to the film's unaccrued ultimate participation costs as of the beginning of the fiscal year, and the difference between expenses determined using the new estimates and any amounts previously expensed during that fiscal year should be charged or credited to the income statement in the fiscal year of the revised estimates.

**EXAMPLE: INDIVIDUAL-FILM-FORECAST METHOD
OF AMORTIZATION WHERE ESTIMATES ARE
REVISED SUBSEQUENT TO THE INITIAL YEAR
OF RELEASE**

Given: Film cost—\$100,000

Estimated ultimate revenue:

Year 1—\$200,000

Year 2—\$180,000 (This is not the remaining revenue starting
from this year.)

Actual Revenue earned:

In Year 1—\$120,000

In Year 2—\$20,000

Estimated ultimate participation costs:

Year 1—\$20,000

Year 2—\$18,000

For Year 1, film costs amortization was \$60,000 and
participation costs accrued were \$12,000.

Film cost amortization in Year 2:

$$\begin{array}{rcl} \frac{\$20,000 \text{ earned revenue}}{\$60,000 \text{ remaining ultimate revenue}^2} & \times & \$40,000^1 \text{ unamortized} \\ & & \text{film costs} \\ & = & \$13,333 \end{array}$$

Participation costs accrued in Year 2:

$$\begin{array}{rcl} \frac{\$20,000 \text{ earned revenue}}{\$60,000 \text{ remaining ultimate}} & \times & \$6,000^3 \text{ remaining ultimate} \\ & & \text{participation costs} \end{array}$$

$$\text{revenue} = \$2000$$

¹Film cost of \$100,000 minus cumulative prior amortization of \$60,000.

²Year 2 revised ultimate revenue of \$180,000 minus cumulative prior earned revenue of \$120,000.

³Year 2 revised ultimate participation expense of \$18,000 minus cumulative prior accrued costs of \$12,000.

Ultimate revenue The ultimate revenue that was included in the individual film-forecast-computation method fraction just illustrated includes estimates of revenue that are expected to be recognized by an entity from the exploitation, exhibition, and sale in all markets and territories. However, the following constraints apply:

- For films other than episodic television series, ultimate revenue should include estimates over a period not to exceed 10 years following the date of the film's release.
- For an episodic television series, ultimate revenue should include estimates of revenue over a period not to exceed 10 years from the date of delivery of the first episode.
- For an episodic television series still in production, ultimate revenue should include estimates of revenue over a period not to exceed five years from the date of delivery of the most recent episode (if later than the date of delivery of the first episode).
- Ultimate revenue for an episodic television series should include estimates of all secondary market revenue only if the entity can show that it will be able to successfully license those episodes already produced and those committed to be produced in the secondary market.
- For previously released film acquired as part of a film library, ultimate revenue should include estimates over a period not to exceed 20 years from the date of acquisition. A film library consists of, for purposes of this guidance, those films whose initial release dates were at least three years prior to the acquisition date.
- If persuasive evidence exists that revenue can be generated from a market or territory or a history of such earnings exists, this revenue should be included in estimates of ultimate revenue. Use estimates of revenue from newly developing territories only if an existing arrangement provides convincing evidence that the entity will, in fact, realize such amounts.
- If convincing evidence exists that revenue can be generated from licensing arrangements with third parties to market film-related products (e.g., a contract between the entity and third party exists giving the entity a nonrefundable minimum guarantee or nonrefundable advance), then estimates of such revenue should be included in ultimate revenue.
- Ultimate revenue should include estimates of the portion of wholesale or retail revenue from an entity's sale of such items as toys and apparel (peripheral items) that are attributable to the exploitation of themes, of

themes, characters, or features of a film if the entity can show that there is a history of such revenue generation from, for example, similar kinds of films.

- Estimates of revenue from unproven or undeveloped technologies should not be included in ultimate revenue.
- Estimates of wholesale promotion or advertising reimbursement from third parties should not be included in ultimate revenue. These amounts should be offset against exploitation costs incurred by the entity.
- Estimates of amounts related to the sale of film rights for the following periods should not be included in ultimate revenue:

—For films other than episodic television series, estimates exceeding a period of 10 years following the date of the film's initial release.

—For episodic television series, estimates exceeding a period of 10 years from the date of delivery of the first episode or, if still in production, a period exceeding five years from the date of delivery of the most recent episode, if later.

- Ultimate revenue should be discounted to its present value. All foreign currency estimates of future revenues should be predicated on current spot rates. In addition, ultimate revenue should not include projections for current inflation.

Ultimate participation costs Estimates of unaccrued ultimate participation costs are used in the individual-film-forecast-computation method to arrive at current period participation cost expense. As was noted, such costs are derived based on estimates of film costs, exploitation costs, and ultimate revenue. If at any balance sheet date, the recognized participation costs liability exceeds the estimated unpaid ultimate participation costs for an individual film, the excess liability should be reduced with an offsetting credit to unamortized film costs. To the extent that an excess liability exceeds unamortized costs for that film, it should be credited to income. If a film continues to generate revenue after its film costs are fully amortized, the entity should accrue associated participation costs as the additional revenue is recognized. That is, associated participation costs should be recognized when additional revenue is recorded on fully amortized films.

EXAMPLE: PARTICIPATION LIABILITY THAT IS IN EXCESS OF A REVISED ESTIMATE OF AMOUNTS ULTIMATELY PAYABLE

As previously indicated, a participation liability that exceeds the unpaid amount expected to be ultimately payable should be offset against the remaining carrying value of the corresponding film. This situation can result from the changes in ultimate revenue and cost estimates that result in reduced expectations of ultimate participation costs.

Given: Film cost—\$100,000

Estimated ultimate revenue:

Year 1—\$200,000

Year 2—\$160,000

Actual Revenue earned:

Year 1—\$120,000

Year 2—\$120,000

Estimated ultimate participation costs:

Year 1—\$20,000

Year 2—\$0

In Year 1, film cost amortization was \$60,000 and participation costs accrued were \$12,000.

Adjustments of participation liability and film costs in Year 2:

	<i>Unamortized Film Costs</i>	<i>Participation Liability</i>
Balance at end of Year1	\$40,000 ¹	\$12,000
Adjustment to eliminate excess liability	(12,000)	(12,000)
Adjusted balances	\$28,000	\$ 0

¹Film cost of \$100,000 minus film cost amortization of \$60,000 in Year 1.

Film Cost amortization in Year 2:

$$\frac{\$20,000 \text{ earned revenue}}{\$40,000 \text{ remaining ultimate revenue}^3} \times \$28,000^2 = \$14,000$$

Film Cost amortization in Year 2:

$$\frac{\$20,000 \text{ earned revenue}}{\$40,000 \text{ remaining ultimate revenue}} \times \$0 \text{ remaining ultimate revenue}^4 = \$0$$

²Film costs of \$100,000 minus cumulative prior amortization of \$60,000 minus the excess participation liability adjustment of \$12,000.

³Year 2 revised ultimate revenue of \$160,000 minus cumulative prior earned revenue of \$120,000.

⁴Estimated ultimate participation costs were reduced to \$0 in Year 2. Therefore, the excess liability was reduced and no further accruals were required.

Film costs valuation The following circumstances require an assessment by an entity of the possibility that the fair value of a film, regardless of its completion, is less than its amortized costs:

- There is an adverse change in the expected performance of the film prior to its release.
- Actual costs substantially exceed budgeted costs.
- There are significant delays in its completion or release schedules.
- There is a reduction in the initial release pattern or changes in other release patterns.
- There are insufficient resources (funding) to complete the film and market it effectively.
- Actual performance subsequent to release does not meet prior expectations.

If one or more of these indications or others like them imply that the fair value of a film is less than its unamortized costs, the fair value of the film should be determined. This determination should be influenced by estimated future exploitation costs still to be incurred. The entity should then compare the fair value of the film to the unamortized capitalized costs and write off to the income statement the amount by which the unamortized capitalized costs of the film exceed its fair value. After writing down a film to fair value, the costs that have been written off should never be restored in subsequent periods.

It is common to use a discounted cash flow model to estimate fair value. In estimating the future cash flows for a given film, the following should be considered:

- The public's perception of the film's story, director, producer, and cast.
- Historical results of similar films.
- Historical results of the cast, director, or producer in prior films.
- If previously released, the film's performance in prior markets.
- The running time of the film.
- The degree of cash outflows necessary to generate the film's cash inflows. The entity should incorporate estimates of future costs to complete the film future exploitation, participation costs, and other necessary cash outflows in determining fair value.

When determining the fair value of a film using a traditional discounted cash flow approach, the following additional guidelines should be considered:

- The discount rates should not be an entity's incremental borrow rates, liability settlement rates, or weighed average cost of capital. These rates do not consider the risks associated with a film asset.
- The discount rates used should consider the time value of money and expectations about possible variations in the amount or timing of the most likely cash flows. This rate should also be adjusted to incorporate the uncertainty inherent in a film asset including illiquidity and market imperfections.

Subsequent evidence leading to a write-down of unamortized film costs If a film is released around the entity's balance sheet date and evidence exists that a write-down of the film's unamortized costs is required, then, if entity has not issued its financial statements, it should adjust its financial statements for the effect of any changes in estimates resulting from the use of subsequent evidence. The entity is not required to take such action during the subsequent period if it can be shown that the conditions leading to the write-off did not exist at the date of the balance sheet.

Accounting for advertising costs Advertising costs incurred by an entity should be accounted for in accordance with SOP 93-7, *Reporting on Advertising Costs*. Marketing costs and all other exploitation costs should be expensed as incurred.

Incurrence of manufacturing costs The costs of products for sale, such as videocassettes and digital video discs, should be expensed on a unit-specific basis and charged to manufacturing and/or duplication of products for sale when the related product revenue is recognized. At the balance sheet date, the entity should evaluate its inventory of these products to determine whether adjustments are required when considering their net realizable value and obsolescence exposures. In addition, the costs of theatrical film prints should be expensed over the period that these costs benefit.

Disclosure Film costs should be disclosed as noncurrent assets on the balance sheet if the entity presents a classified balance sheet. Regardless of whether or not the entity's balance sheet is presented as classified, the portion of unamortized costs of its completed films that will be written off during its upcoming presumably 12-month operating cycle should be disclosed in the financial statements. In addition, the components of film costs should be separately shown as theatrical films and direct-to-television products. These film costs (within each of the two categories) should be further divided into the following classifications including: released; completed and not released; in production; or in development or preproduction.

An entity should disclose the percentage of unamortized film costs for released films (excluding acquired film libraries) that it plans to amortize within three years from the entity's balance sheet date. If the percentage is less than 80%, the entity must disclose the period required to reach that amortization level (80%). For acquired film libraries, an entity must disclose the amount of unamortized costs that remains, the method of amortization, and the amortization period that is being used.

The following miscellaneous disclosure guidelines should also be followed:

- The amount of accrued participation liabilities that an entity expects to pay during the upcoming operating cycle should be disclosed.
- Cash flows for film costs, participation costs, exploitation costs, and manufacturing costs should be disclosed by the entity in the operating activities section of its Cash Flow Statement. The amortization of film costs in the reconciliation of net income to net cash flow from operating activities should also be shown.

- The method of accounting for revenue, film costs, participation costs, and exploitation costs should be disclosed.
- The entity should disclose the effect on income before extraordinary items, net income, and related per-share amounts of the current fiscal period for a change in estimate that affects several future periods.
- Events occurring subsequent to the date of the balance sheet that do not require an adjustment to the financial statements but require disclosure so as to keep the financial statements from being misleading should be shown.

CHAPTER 15

NOT-FOR-PROFIT ORGANIZATIONS

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Describe the types of and components of financial statements mandated by GAAP
- Distinguish non-for-profit organizations from other entities.
- Prepare financial statements for not-for-profit organizations.
- Explain how financial accounting and reporting for private not-for-profit organizations differs from that of state and local governments.

TERMINOLOGY

Control. The ability to determine the direction of management and policy for purposes of presenting combined financial statements.

Voluntary health and welfare organizations (VHWOs) Tax exempt, not-for-profit supported by public donations. They are primarily designed to solve the health and welfare problems of individuals and overall society.

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in not-for-profit organizations are:

- SFAS 116 (*Accounting for Contributions Received and Contributions Made*).
- SFAS 117 (*Financial Statements of Not-for-Profit Organizations*).
- SFAS 124 (*Accounting for Certain Investments Held by Not-for-Profit Organizations*).
- SFAS 133 (*Accounting for Derivative Instruments and Hedging Activities*).
- SFAS 136 (*Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*).
- SFAS 144 (*Accounting for the Impairment or Disposal of Long-Lived Assets*).
- SFAC 4, *Objectives of Financial Reporting by Nonbusiness Organizations*.
- SFAC 6, *Elements of Financial Statements*.

RULES, CONCEPTS, AND ILLUSTRATIONS

Resource providers of not-for-profit (nonbusiness) organizations have as their primary concerns the services rendered by the organization and the continuing ability of the organization to render those services. Business organizations obtain resources by providing goods and services. Many not-for-profit organizations obtain resources from

contributors and are accountable to the providers of those resources or to their representatives.

SFAC 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, states that the objectives of financial reporting are derived from the common interests of those who provide the resources to nonbusiness organizations. Such organizations ordinarily have no single indicator of performance comparable to a business enterprise's profit. Thus, nonbusiness organization performance is usually evaluated in terms of management stewardship.

Financial reporting by nonbusiness organizations should provide information useful in

1. Making resource allocation decisions.
2. Assessing services and the ability to continue to provide services.
3. Assessing management stewardship and performance.

Additional objectives are to provide information about the liquidity of the organization, economic resources, obligations, net resources, and changes in them, including managers' explanations and interpretations.

In general, GAAP requires not-for-profit organizations to issue a statement of financial position, a statement of activities, and a statement of cash flows. According to SFAS 117, the focus is on the organization as a whole and on reporting assets, liabilities, and net assets; changes in net assets; flows of economic resources; cash flows, borrowing and repayment of borrowing, and other factors affecting liquidity; and service efforts.

Not-for-profit organizations' classification of net assets, revenues, expenses, gains, and losses are based on whether there are restrictions by donors. Net assets in the statement of financial position must be categorized as being permanently restricted, temporarily restricted, or unrestricted.

The amount of change in each of these classes must also be disclosed in a statement of activities. In addition, expiration of donor-imposed restrictions is required to be disclosed in the period in which the restrictions expire as are restrictions that increase one class of net assets and decrease another (reclassifications). The latter should be reported separately from other transactions in the statement of activities. Investments in equity securities with readily determinable fair values and all investments in debt securities should be reported at fair value with gains and losses disclosed in the statement of activities.

Typical users of financial reports of nonbusiness organizations include:

1. Resource providers.
2. Constituents.
3. Governing and oversight bodies.

Others potentially interested in the financial information provided by nonbusiness organizations include managers, organization members, taxpayers, contributors, grantors, lenders, suppliers, creditors, employees, directors and trustees, service beneficiaries, financial analysts and advisers, brokers, underwriters, lawyers, economists, taxing authorities, regulatory authorities, legislators, the financial press, labor unions, trade associations, researchers, teachers, and students.

KEY GAAP

Under SFAS 117, a complete set of financial statements for a not-for-profit organization (NFPO) consists of a statement of financial position (SFP) as of the end of the reporting period, a statement of activities (SOA), and a statement of cash flows (SCF) for the reporting period, and accompanying notes to the financial statements. A voluntary health and welfare organization (VHWO) must also provide a statement of functional expenses, which reports expenses by functional as well as natural classification. VHWOs are tax exempt, are supported by public donations, and operate on a not-for-profit basis. They are primarily designed to solve the health and welfare problems of individuals and overall society.

Statement of Financial Position (SFP)

The SFP reports the pertinent data about the entity's assets, liabilities, and net assets as well as their interrelationship to each other at a cumulative point in time. This information (together with data from other financial statements and disclosures) assists donors, creditors, members of the organization itself, and others to determine the entity's ability to continue to provide services. In addition, it allows for the assessment of the NFPO's liquidity, solvency, and financial flexibility needed to obtain external financing and satisfy its day-to-day debts.

An NFPO's SFP must report amounts for each of three classes of net assets: permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets. Each of these classes is discussed below:

- *Permanently restricted net assets.* That part of an NFPO's net assets that result from:
 - Contributions and other inflows of assets whose use by the organization is limited by donor-imposed restrictions that do not expire or cannot be satisfied or removed by actions taken by the organization.
 - Other asset increases and reductions that are also restricted.
 - Reclassifications from or to other net asset classifications as a result of donor imposed terms.
- *Temporarily restricted net assets.* That part of an NFPO's net assets that results from:
 - Contributions and other inflows of assets whose use by the organization is limited by donor-imposed restrictions that either expire by the passage of

- time or can be satisfied or removed by actions taken by the organization.
- Other asset augmentations and reductions that occur as a result of the conditions just described.
- Reclassifications from or to other net asset classifications as a result of donor-imposed terms, expiration as a passage of time, or satisfaction and removal by actions of the organization.

- *Unrestricted net assets.* That part of the net assets of an NFPO's net assets that are neither permanently nor temporarily restricted by requests of the donor.

Information relating to the nature and amounts of varying permanent restrictions or temporary restrictions should be shown by reporting their amounts on the face of the SFP or including such data in the notes to the entity's financial statements.

Unrestricted net assets are generally constrained only by broad limits resulting from the nature of the organization, its operating environment, legal restrictions specified in the entity's articles of incorporation, or any contracts that the entity might have signed during the course of doing business. Any such constraints, together with self-imposed limits by the organization itself, should be shown in the notes of the financial statements.

Statement of Activities (SOA)

The SOA (together with disclosures and information in the NFPO's other financial statements and note disclosures) enables donors, creditors, and other readers to:

- Determine the entity's performance during a given period of time.
- Gauge the organization's service efforts and its ability to continue to perform services.
- Appraise the success or failure of management's performance.

Specifically, the SOA measures:

- The results of transactions and other occurrences that change the amount and nature of the NFPO's net assets.
- The relationship of those transactions and occurrences to each other.
- How the entity's resources are being used in relation to its ongoing programs and services.

The SOA reports the amount of change in permanently restricted net assets, temporary restricted net assets, and unrestricted net assets for the period. Expirations of donor-imposed restrictions that increase one class of net assets and decrease another through reclassification are required to be reported as separate items. Revenues should be reported as increases in unrestricted net assets unless use of the assets received is limited by donor-imposed restrictions. In addition, an SOA should report expenses as decreases in unrestricted net assets. It should also report gains and losses recognized on investments and other assets (or liabilities) as increases or decreases in unrestricted net assets unless

restricted by law or donor requests. An NFPO is not prevented from classifying its revenues, expenses, gains, or losses within classes of net assets with additional classifying captions within the SOA (e.g., operating, nonoperating, expendable, nonexpendable). If an intermediate determinant of operations is reported (e.g., operating income, operating surplus, operating profit, operating deficit), this information should be reported in a financial statement that, at the very least, reports the change in unrestricted net assets for the period.

To ensure that readers of the SOA clearly understand the NFPO's major operations and activities, the SOA should report the gross amount of its revenues and expenses. Investment revenues, on the other hand, may be shown net of related expenses, such as custodial fees or advisory costs. However, they must be disclosed either on the face of the SOA or in the notes to the financial statements. Costs of services, consumption of resources, and information about expenses should be reported by their functional classification, such as major classes of program services (activities resulting in goods and services being distributed to beneficiaries or customers, for example, that satisfy the objectives of the NFPO) and supporting activities (all activities other than program services, such as management and general activities, fund-raising, and membership activities). Expenses of nonprofit organizations are incurred for either program services or supporting services. Program expenses relate directly to the primary mission of the organization. Expenses of supporting services do not. VHWOs should report this information by natural classification, such as salaries, rent, utilities, interest expense, and depreciation.

Statement of Cash Flows (SCF)

The SCF provides readers with data regarding the cash receipts and cash payments of the organization during the year. Guidelines regarding the information that is provided to users of an NFPO's SCF and the standards for its preparation are covered in the statement of cash flows section relating to a business enterprise (SFAS 95). SFAS 95 as amended by SFAS 117 requires a statement of cash flows as part of a full set of financial statements of all business entities (both publicly held and privately held) and not-for-profit organizations. Defined benefit pension plans, certain other employee benefit plans, and certain highly liquid investment companies, however, are exempted from this requirement by SFAS 102.

Contributions Received

SFAS 116, *Accounting for Contributions Received and Contributions Made*, establishes standards of accounting and reporting for contributions. It applies to all organizations that receive or make contributions. When contributions are received by an NFPO, they must be classified as permanently restricted, temporarily restricted, or without donor-imposed limitations. Contributions that are restricted increase permanently or temporarily restricted net assets, and those that do not have donor-imposed stipulations increase unrestricted net assets. Unconditional promises to make contributions (make payments) that are expected in future periods should be classified as restricted support unless the donor clearly indicated the money is to be used for activities in the current period. Specifically, unless indicated otherwise, receipts of unconditional support of cash in the future generally increase temporarily restricted net assets.

According to SFAS 116, contributions received should be accounted for at fair value as revenues or gains and as assets, decreases of liabilities, or expenses, depending on the form of benefits received. Contributions of services are recognized if they require special skills, are provided by individuals having those skills, and would have to be purchased if not received by donation.

Contributions of such items as art works and historical treasures need not be capitalized and recognized as revenues if they are added to collections that are (1) subject to a policy that requires the proceeds of sale of collection items to be used to acquire other collection items; (2) protected, kept unencumbered, cared for, and preserved; and (3) held for public exhibition, education, or research for public service purposes rather than financial gain. If they are not capitalized, the entity must report on the face of the statement of activities (separately from revenues, expenses, gains, and losses) the costs (proceeds) of collection items purchased (sold) as a decrease (increase) in the appropriate class of net assets. The entity also must disclose the proceeds from insurance recoveries of lost or destroyed collection items as an increase in the appropriate class of net assets. Furthermore, the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*, states that cash flows from purchases, sales, and insurance recoveries of uncapitalized collection items are reported in the investing activities section of the statement of cash flows.

SFAS 116 defines a contribution of utilities, such as electricity, as a contribution of other assets, not a contribution of services. A simultaneous receipt and use of utilities should be recognized as both an unrestricted revenue and expense in the period of receipt and use. The revenue and expense should be measured at estimated fair value. This estimate can be obtained from the rate schedule used by the utility company to determine rates charged to a similar customer.

Contributions of services by the professional carpenters should be capitalized. Under SFAS 116, the contributions of services requiring specialized skills, such as those of carpenters, electricians, etc., should be recognized if they are provided by individuals possessing those skills and would typically need to be purchased if not provided by donation. SFAS 116 also requires that donated services creating or enhancing nonfinancial assets be recognized even though specialized skills are not involved. Because the members' labor helped rebuild the church, their contributions of services also should be capitalized.

Expiration of Donor-Imposed Restrictions

The expiration of a donor-imposed restriction on a contribution should be recognized in the period in which the restriction expires. This occurs when (1) the purpose for which the resource was restricted has been satisfied, (2) the time of the imposed restriction has elapsed, or (3) both of these criteria occur. For example, a donor established a memorial fund for a loved one that requires that the money (accounted for as revenue or a gain in the period in which it was received) be invested in a certain type of investment (i.e., Bonds) for 10 years. The contribution must be classified as restricted support in the period of receipt. After the donor-imposed restriction is satisfied (i.e., after the 10 years have passed), the

entity must report a reclassification that shows that its unrestricted net assets have increased and temporarily restricted net assets of the entity has decreased.

Investments Held by NFPO

The following discussion relating to accounting for investments held by NFPOs does not apply to the following situations:

- Investments in equity securities that are accounted for under the equity method.
- Investments in consolidated subsidiaries.
- Investments in derivative instruments that are subject to SFAS 133 (*Derivative Instrument and Hedging Activities*) and related pronouncements.

According to SFAS 124 (*Accounting for Certain Investments Held by Not-for-Profit Organizations*), in its statement of financial position, a not-for-profit organization should measure the following investments at fair value: (1) equity securities with readily determinable fair values and (2) debt securities. Thus, the total change in the fair value of the donated securities from the date of receipt to the balance sheet date must be reported in the statement of activities. If a fair value cannot be obtained for a debt security, a reasonable estimate (using market prices for similar securities, present value of expected future cash flows, and other such techniques) should be made for those debt securities for which fair value cannot easily be obtained because they are limitedly traded.

Disclosing Investment Income, Gains, and Losses

Gains and losses on investments must be reported in the SOA as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by the donor or by law. Similarly, interest, dividends, and other investment income must be reported as increases in unrestricted net assets in the period earned unless the use of the underlying assets that were received were restricted by the donor. Investment income that is restricted (depending on the type of restriction mandated by the donor) must be reported as an increase in temporarily restricted net assets or permanently restricted net assets. If restrictions relating to gains and investment income are satisfied in the same reporting period as these items are recognized, the gains and income limited by donor-restricted stipulations may be reported as increases in unrestricted net assets.

Endowment Funds that Are Donor Restricted

In a donor-restricted endowment fund, the donor stipulates that a gift must be invested in perpetuity or for a specified period of time. Gains and losses on investments of donor-restricted endowments should be reported as changes in unrestricted net assets unless the gains and losses are temporarily or permanently restricted by the donor or by law. That is, if a donor requires that a particular investment be permanently restricted, the gains and losses on this investment must also be permanently restricted unless otherwise specifically stipulated. On the other hand, if the donor does not require that the investment be held in such a manner—that is, the organization is allowed to choose whatever investments it desires—the gains are not permanently restricted unless the donor or law requires such a restriction. In general, losses on the investments of a donor-restricted

endowment fund should be used to reduce temporarily restricted net assets to the extent that donor imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any loss that remains after this shall be used to reduce unrestricted net assets. If a donor-restricted endowment fund is reduced by losses below the level required by the donor or law, any gains that restore the fair value of the assets of the endowment fund to that minimally required level should be classified as increases in unrestricted net assets.

The board of directors of the NFPO may create an endowment of unrestricted monies. Losses on investments of such a fund are classified in unrestricted net assets. All sources of such an endowment fund, including the original investment, gains and losses, interest and dividends, do not have any donor restrictions.

Financial Statement Disclosures

Statement of activities The SOA of an NFPO is required to have the following disclosures for each period presented:

- The details of the NFPO's investment return for the period, including:
 - Investment income.
 - Net realized gains or losses on investments reported at other than fair value.
 - Net gains or losses on investments reported at fair value.
- If investment return is separated into operating and nonoperating amounts, a reconciliation of this return to amounts reported in the statement of activities.
- A description of the policy used to determine the amount that is included in measuring operations and, if a change was made in that policy, a discussion of the cause leading to such a change.

Statement of financial position The SFP of an NFPO is required to present the following disclosures for each period:

- Carrying amounts of investments disclosed in the aggregate and classified by major types, including equity securities, U.S. Treasury securities, corporate debt securities, mortgage-backed securities, real estate, and oil and gas properties.
- A description of how the basis was determined for the carrying amounts for all debt and investments other than equity securities with readily determinable fair values.
- A description of the significant assumptions and methods used to estimate the fair values of investments other than financial instruments if those other investments are reported at fair value.
- Where the fair value of the assets at the reporting date for all donor-restricted endowment funds is less than the level required by donor restriction or law, the aggregate amount of these deficiencies.

Other Disclosure Requirements

Concentration of credit risk An NFPO is required (for the most recent period for which an SFP is presented) to enumerate the nature of and carrying amount for each individual investment or group of investments that represents a significant concentration of market risk that results from lack of diversity of industry currency, geographic location, or nature of the investments itself. SFAS 133 requires that an entity disclose all significant concentrations of credit risk arising from financial instruments, whether from an individual counterparty or groups of counterparties. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions (e.g., if all an NFPO's receivables were from customers in the same industry or same region of the nation). If an economic downturn occurred affecting that industry or region, the collectibility of those receivables would be significantly reduced.

Transfers of assets by an NFPO to a charitable trust or another NFPO that raises or holds contributions for others

If an NFPO transfers assets to another organization (the recipient organization) and specifies itself or another as the beneficiary or its affiliate, the following disclosures must be presented in its SFP for each period:

- Recognition of the recipient organization of the transfer.
- Recognition of whether that recipient organization was given variance power and the terms of such power.
- The terms under which amounts will be distributed to the resource provider or its affiliate.
- The aggregate amount recognized in the SFP for those transfers and determination of whether that amount is recorded as an interest in the net assets of the recipient organization or as another asset (e.g., refundable advance or beneficial interest in assets held by others).

SFAC 6 (Elements of Financial Statements)

SFAC 6, *Elements of Financial Statements*, cover not-for-profit entities. It defines 10 interrelated elements of financial statements that are directly related to measuring the performance and status of an entity. Of these, seven are found in statements of both business and not-for-profit entities: assets, liabilities, equity or net assets, revenues, expenses, gains, and losses. Investments by owners, distributions to owners, and comprehensive income are elements of financial statements of business enterprises only.

SFAS 136 (Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others).

Under SFAS 136, a specified beneficiary recognizes its rights to the financial or nonfinancial assets held by a recipient as an asset unless the donor has explicitly granted the recipient variance power. If the beneficiary and the recipient are financially interrelated, the beneficiary must recognize its interest in the recipient's net assets. That

interest is adjusted for the beneficiary's share of the change in net assets of the recipient in a way that is similar to the equity method.

No contribution is involved when the resource provider or its affiliate is the specified beneficiary. If the transfer also involves a recipient that is financially interrelated with the resource provider and if neither party expects payment of the transferred assets, an equity transaction must be accounted for. If the resource provider itself is the specified beneficiary, its entry is to debit an interest in net assets of the recipient (similar to the investment account when the equity method is used) and to credit an asset or payable.

SOP 94-3 (Reporting of Related Entities by Not-for-Profit Organizations)

SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, prescribes the reporting when an NPO holds an investment in a for-profit entity or is related to a separate NPO.

If one NPO has (1) control over and (2) an economic interest in another NPO, consolidation of the entities is permitted but not required when control is not achieved through (a) majority ownership other than by a majority voting interest, (b) a majority voting interest, or (c) a majority voting interest in the other NPO's board.

In accordance with ARB 51, as amended by SFAS 94, *Consolidation of All Majority Owned Subsidiaries*, a parent should consolidate the financial position, results of operations, and cash flows of an investee in its financial statements if the parent has a controlling financial interest through direct or indirect ownership of a majority (more than 50%) voting interest. An exception to this rule is made only when control does not rest with the majority owner, for example, when the investee is in bankruptcy. SOP 94-3 applies the foregoing principles when the parent is an NPO and the investee is a for-profit entity.

CHAPTER 16

OIL- AND GAS-PRODUCING ACTIVITIES

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- List types of assets utilized in oil and gas producing activities.
- Account for acquisition costs of properties.
- Account for exploration and related costs.
- Discuss amortization, depreciation and depletion related to oil and gas production activities.
- Account for income taxes in the oil and gas industry.
- Capitalize interest cost under the full cost method.
- Summarize disclosure requirements.

TERMINOLOGY

Mineral interests in properties. Generally referred to as *properties*, fee ownership or a lease, concession, or other interest that provides the right to extract oil or gas.

Proved properties. Properties with proved reserves.

SOURCES OF GAAP

The key sources of authoritative GAAP relating to guidance in oil- and gas-producing enterprises include:

- SFAS 19 (*Financial Accounting and Reporting by Oil and Gas Producing Companies*).
- SFAS 25 (*Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies*).
- SFAS 69 (*Disclosures about Oil and Gas Producing Activities*).
- SFAS 95 (*Statement of Cash Flows*).
- SFAS 109 (*Accounting for Income Taxes*).
- SFAS 131 (*Disclosures about Segments of an Enterprise and Related Information*).
- SFAS 143 (*Accounting for Asset Retirement Obligations*).
- SFAS 144 (*Accounting for the Impairment or Disposal of Long-Lived Assets*).
- SFAS 145 (*Rescission of SFAS 4, 44, and 64, Amendment of SFAS 13, and Technical Correction*).
- FASB Interpretation No. 36 (*Accounting for Exploratory Wells in Progress at the End of a Period*).
- FASB Staff Position FAS 19-1

RULES, CONCEPTS, AND ILLUSTRATIONS

GAAP has followed a circuitous path in the establishment of guidelines relating to oil- and gas-producing companies. SFAS 19 required that oil and gas entities follow the successful efforts approach. After strong opposition from small oil and gas producers, the SEC examined both the successful efforts approach and the full cost approach and found both methodologies to be lacking. In place of them, the SEC believed that an alternative method would be appropriate. This alternative, entitled Reserve Recognition Accounting (RRA), had not yet been fully developed. In response to the SEC's decisions, the FASB then issued Statement No. 25, which suspended the requirement that the successful efforts approach be used. However, because of many insurmountable estimation problems relating to the RRA method, the SEC abandoned its choice and established guidelines that allowed oil and gas companies to use either the successful efforts approach or the full cost approach. (The full cost method of accounting requires that all exploratory costs be capitalized because these represent integral cost of locating the existence of productive wells. Smaller exploration oriented oil companies generally use the full cost method. The successful efforts method of accounting requires that only exploratory costs of successful wells be capitalized; exploratory costs of unsuccessful wells are expensed. Many successful, large oil companies use the successful efforts approach.) However, because of the importance of value-based disclosures relating to oil and gas reserves advocated by the RRA method, SFAS 69 was passed, requiring current value disclosures relating to oil- and gas-producing activities.

SFAS 69 establishes comprehensive financial statement disclosures that supersede the disclosure requirements of SFAS 19 and SFAS 25. It also incorporates the SEC's disclosure requirements relating to oil- and gas-producing requirements. Comprehensive guidelines relating to the full cost approach are described in regulations published by the SEC. Although many required compliance provisions of SFAS 19 have been suspended, these standards have been issued by the SFAS and still remain in existence. In addition, SFAS 19's requirements relating to reporting accounting changes and allocating income taxes have not been suspended.

With respect to the results of operations for oil- and gas-producing activities, SFAS 69 requires that the following information be presented for the year:

- Revenues.
- Production (lifting) costs.
- Explorations expenses.
- Depreciation, depletion, amortization, and valuation provisions.
- Income tax expenses.
- Results of operations for oil-and gas-producing activities (excluding corporate overhead and interest costs).

SFAS 69 also requires that publicly traded enterprises with significant oil and gas activities disclose the following as supplementary information with their financial statements:

- Proved oil and gas reserve quantities.
- Capitalized costs relating to oil- and gas-producing activities.
- Costs incurred in oil and gas property acquisition, exploration, and development activities.
- Results of operations for oil- and gas-producing activities.
- A standardized measure of discounted future net cash flows relating to proved oil and gas reserve quantities.

KEY GAAP

Types of Assets Utilized in Oil-and Gas-Producing Activities

An oil- and gas-producing entity is involved in activities that require special types of assets. The costs of these assets should be capitalized when they are incurred. The following are definitions of the special types of assets that are used in the oil- and gas-producing industry:

Mineral interests in properties Generally referred to as *properties*, these include fee ownership or a lease, concession, or other interest that provides the right to extract oil or gas. Properties may also include royalty interests, production payments that are payable in oil or gas, and agreements with foreign governments under which an entity participates in the operation of the properties or serves as producer of the underlying reserves. Properties do not include other supply agreements or contracts that represent the right to purchase rather than extract oil and gas. Properties are classified as being proved or unproved.

Proved properties. Proved properties are properties with proved reserves. Proved reserves consist of proved oil and gas reserves, proved developed oil and gas reserves, and proved undeveloped reserves. A discussion of these three components follows.

Proved oil and gas reserves include estimated quantities of crude oil, natural gas, and natural gas liquids that geological and engineering data demonstrate with a substantial degree of certainty to be recoverable in future years from known reservoirs. The following characteristics relate to these properties:

- Reservoirs are considered to be proved if economic producibility is supported by either actual production or conclusive formation tests.
- Reserves that can be produced economically through the application of improved recovery techniques (e.g., fluid injection) are included in the proved classification if successful testing by a pilot project, or the operation of an installed program in the reservoir, provides support for the engineering analysis on which the program was based.
- Estimates of proved reserves do not include the following:
 - Oil that may become available from known reservoirs but is classified separately as indicated additional reserves.
 - Crude oil, natural gas, and natural gas liquids, the recovery of which is subject to reasonable doubt because of uncertainty as to geology, reservoir characteristics, or economic factors.

- Crude oil, natural gas, and natural oil gas liquids that may occur in undrilled prospects.
- Crude oil, natural gas, and natural gas liquids that may be recovered from oil shales, coal, and other such sources.

Proved developed oil and gas reserves are reserves that can be expected to be recovered through existing wells with existing equipment and operating methods. Additional oil and gas expected to be obtained through the application of fluid injection or other improved recovery techniques for supplementing the natural forces of primary recovery should be included as proved developed reserves only after testing by a pilot project or after the operation of an installed program has confirmed, through production response, that increased recovery will in fact be accomplished.

Proved undeveloped reserves are reserves that are expected to be recovered from new wells on undrilled acreage, or from existing wells for which a relatively major expenditure is required for recompletion. Reserves on undrilled acreage should be limited to those drilling units offsetting production units that are reasonably certain of production when drilled. Proved reserves for other undrilled units can be claimed only if it can be demonstrated with certainty that there is continuity of production from the existing productive formation.

Unproved properties. These are properties with no proved reserves.

Wells and related equipment and facilities These include the costs of items incurred to:

- Drill and equip the exploratory wells and exploratory-type stratigraphic test wells that have found proved reserves. Stratigraphic test wells are drilling projects that are geologically directed to obtain information pertaining to specific geological information.
- Obtain access to proved reserves and provide facilities for extracting, treating, gathering, and storing the oil and gas, including the drilling and equipping of development wells (a productive well drilled within the proved area of an oil or gas reservoir drilled down to the stratigraphic horizon) and development-type stratigraphic test wells and service wells (a well drilled for the purpose of supporting production in an existing field).

Support equipment and facilities used in oil- and gas-producing activities These include such items as drilling equipment, construction and grading equipment, seismic equipment, vehicles, repair shops, warehouses, and supply points.

Uncompleted wells, equipment, and facilities The costs of these assets include those incurred to (1) drill and equip wells that are not yet completed and (2) acquire or construct equipment and facilities that are not yet completed and installed.

Accounting for Incurred Costs

Property Acquisition SFAS 19 requires that acquisition costs that are incurred to acquire a property (whether unproved or proved) through purchase, lease, or when incurred.

Examples of these expenditures include:

- Lease bonuses.
- Options to purchase or lease properties.
- Portions of costs applicable to minerals when land including minerals rights is purchased.
- Brokers' and legal fees.
- Other related acquisition costs

Exploration Exploration involves:

- Identifying those areas that warrant examination.
- Examining those areas that have been determined to contain oil and gas reserves.

Exploration costs may be incurred both before acquiring a given property (prospecting costs) and after its acquisition. The principal types of exploration costs (including depreciation and operating costs of support equipment and facilities; see the subsequent section on support equipment and facilities) and other costs of exploration activities consist of:

- Geological and geophysical costs, such as topographical and geophysical studies, rights of access to properties to conduct these studies, and salaries of geologists.
- Costs of carrying and retaining undeveloped properties.
- Dry hole contributions and bottom hole contributions.
- Costs of drilling and equipping exploratory wells.
- Costs of drilling exploratory-type stratigraphic test wells.

Other exploration costs Geological and geophysical exploration costs and the costs of carrying and retaining undeveloped properties should be charged to expense when they are incurred.

The costs of drilling exploratory wells and the costs of drilling exploratory-type stratigraphic test wells should be capitalized as part of the entity's uncompleted wells, equipment, and facilities pending determination of whether the well has found proved reserves. Based on what is found, the following accounting procedures should be followed:

- If proved reserves have been found by the well, the capitalized costs of drilling the well should become part of the entity's wells and related equipment and facilities.
- If proved reserves have not been found by the well, the capitalized costs of

drilling the well, net of salvage value, should be charged to expense.

It is common for an oil- and gas-producing entity to perform exploration activities on a property owned by another in exchange for the contractual right to receive an interest in the property if proved reserves are found to exist. If, in fact, proved reserves are found, the costs should become part of the proved property acquired. Alternatively, if proved reserves are not found, the entity performing the exploration activities is due reimbursement for the costs incurred and should account for them as a receivable.

Development Development costs are incurred by oil- and gas-producing companies to obtain access to proved reserves and to provide facilities for extracting, treating, gathering, and storing the oil and gas. Development costs are incurred to:

- Prepare and allow for access to well locations for drilling, including determining specific drilling sites, clearing ground, draining, road building, and relocating public roads, gas lines, and power lines, and other considerations necessary in the development of proved reserves.
- Drill and equip development wells, development-type stratigraphic wells, and service wells, including the costs of platforms and well equipment such as casing, tubing, pumping equipment, and the wellhead assembly.
- Acquire, construct, and install production facilities. These include lease flow lines, separators, treaters, heaters, manifolds, measuring devices, production storage tanks, natural gas cycling and processing plants, and utility and waste disposal systems.
- Provide improved recovery systems.

SFAS 19 notes that all costs incurred to drill and equip development wells, development-type test wells, and service wells are, in fact, development costs and should be capitalized whether or not the well is successful. All costs incurred in the drilling of those wells as well as the costs of constructing equipment and facilities should be included in the entity's uncompleted wells, equipment, and facilities until drilling or construction is completed. At completion, the costs become part of these assets costs.

Costs of production The production process involves bringing the oil and gas to the surface as well as gathering, treating, field processing, and storing them. Production costs include those costs needed to operate and maintain an entity's wells, related equipment, and facilities; depreciation; and other costs of operating support equipment and facilities

These costs become part of the oil and gas that is produced. The following are examples of production costs incurred in lifting gas and oil to the surface:

- Costs of labor to operate the wells and related equipment and facilities.
- Repairs and maintenance.
- Materials, supplies, and fuel consumed, and services utilized in operating the wells and related equipment and facilities.

- Property taxes and insurance applicable to proved properties and wells and related equipment and facilities.
- Severance taxes.

In addition to the aforementioned production costs, depreciation, depletion, amortization of capitalized acquisition, exploration, and development costs also become part of the cost of oil and gas produced.

Support equipment and facilities Support equipment and facilities include such items as seismic equipment, construction and grading equipment, vehicles, repair shops, warehouses, supply points, camps, and division, district, or field offices. SFAS 19 requires that all costs of acquiring or constructing support equipment and facilities should be capitalized. Some support equipment or facilities may have been acquired or constructed for a single activity, including exploration, development, or production. Others may serve two or more of these activities and may also serve in the transportation, refining, and marketing activities of the enterprise. If support equipment and facilities are used in oil- and gas-producing activities, their depreciation and operating costs are considered exploration, development, or production costs based on the specific use.

Disposition of Acquisition Costs after Capitalization

Acquisition costs of proved properties and the costs of wells and related equipment and facilities should be amortized and become part of the cost of oil and gas that is produced. In general, if impairment of unproved properties is found to exist, it should be recognized. In addition, the costs of exploratory wells or exploratory-type stratigraphic test wells should be charged to expense if it is ascertained that the wells have not realized proved reserves.

The following discussion of GAAP augments these concepts related to the disposition of capitalized acquisition costs.

Assessment and reclassification of unproved properties A periodic assessment of unproved properties should be made to ascertain whether impairment has occurred. Impairment is likely to have occurred if, for example, a dry hole has been drilled on it and the entity has no plans to continue drilling in the future. In general, if drilling has not begun on the property or nearby properties, the probability of its partial or total impairment increases as the expiration of the lease term approaches. If, in fact, impairment is indicated in a periodic assessment, a loss should be recognized through the use of a valuation allowance account.

A property should be reclassified from an unproved to a proved property when proved reserves are discovered on or are otherwise attributed to the property.

Depletion and Depreciation Considerations

Depletion of proved properties Capitalized acquisition cost of proved properties should be depleted (amortized) by the unit-of-production method. By doing so, each unit-of-production is assigned a pro rata portion of the unamortized acquisition costs. The unit-of-production method may be applied on a property-by-property basis or on the basis

of some reasonable aggregation of properties with a common geological structural feature or stratigraphic condition, such as a reservoir or field. The unit cost should be computed on the basis of the total estimated units of proved oil and gas reserves. The total amount of depletion is then computed based on the number of units produced in the current period. Unit-of-production depletion rates should be reevaluated whenever needed, but at least once a year. All such revisions should be accounted for prospectively as changes of accounting estimates.

Depreciation of exploratory drilling and development costs Capitalized costs of exploratory wells and exploratory-type stratigraphic test wells that have found proved reserves and capitalized development costs should also be depreciated by the unit-of-production method. Similar to proved properties, the depreciation should be computed either on a property-by-property basis or on the basis of some reasonable aggregation of properties with a common geological or stratigraphic condition, such as a reservoir or field. The unit cost should be computed on the basis of total estimated units of proved developed reserves rather than on the basis of all proved reserves, which is the basis of depleting acquisition costs of proved properties. As with proved properties, unit-of-production depreciation rates should be revised whenever there appears to be a need for such a revision. However, the revision must occur at least once a year. Such revisions should be accounted for as changes in accounting estimates.

Depreciation of support equipment and facilities Depreciation of support equipment and facilities should be accounted for as either exploration cost, development cost, or production cost based on the assets' specific use.

Dismantlement, restoration, and abandonment costs Obligations for these costs must be accounted for in accordance with SFAS 143, *Accounting for Asset Retirement Obligations*. Salvage values must be considered in determining amortization and depreciation rates.

Amortization of Oil and Gas Reserve Costs That Are Produced Jointly

Many properties contain a combination of oil and gas reserves. This presents a problem for amortizing capitalized costs using the unit-of-production method, which requires that the number of current units of oil or gas produced be determined and be compared to the total units of gas or oil reserves in a property or group of properties to be estimated. In those cases where a combination of oil and gas resources is present, the gas and oil produced should be converted to a common unit of measure on the basis of their approximate relative energy content without considering their relative sales value.

If, on the other hand, the relative proportion of gas and oil extracted in the current period is expected to be the same throughout the remaining life of the property, the unit-of-production methodology may be computed on the basis of only one of the minerals. In addition, if either oil or gas dominates both the reserves and current production (evaluated on the basis of relative energy content), the unit-of-production process should be computed on the basis of the dominant mineral only.

Information that surfaces after the balance sheet date Any information that becomes known after the balance sheet date but before the financial statements are issued should be considered as having existed at the balance sheet date. For example, information that may be ascertained regarding the assessment of an unproved property during the period subsequent to yearend but prior to the financial statements issuance should be considered to have existed at the balance sheet date and should be disclosed. In addition, if an exploratory well is in progress at the end of a financial period and is determined not to have any proved reserves before the financial statements are issued, the costs incurred up until the end of the period, net of any salvage, should be charged to expense for this period. However, previously issued financial statements should not be retroactively restated for this new information.

Surrender or abandonment of properties SFAS 19 requires that when an unproved property is surrendered, abandoned, or determined to be worthless, all capitalized acquisition costs should be charged off against the related allowance that has been provided for impairment. When the allowance is insufficient, a loss should be recognized.

If only a single well or piece of equipment is abandoned or retired as part of an individual property or group of proved properties (constituting an overall amortization base), and the remainder (of the property or group) continues to produce oil or gas, then no gain or loss should be recognized on the abandonment or retirement. Instead, the assets being abandoned or retired should be considered to be fully amortized and their cost should be charged to accumulated depreciation, depletion, or amortization. When the last well on an individual property or group of properties (on which amortization is aggregately computed) ceases to produce and the entire property or group is abandoned, a gain or loss should be recognized. A loss is also recognized if a partial abandonment or retirement of a proved property or group of proved properties, or the abandonment or retirement of wells or related equipment, results from a catastrophic event or other major abnormality.

Mineral property conveyances Mineral interests in properties are commonly conveyed to others. This may be due to a desire to obtain financing, spread risks, improve operating efficiency, and achieve tax benefits.

Conveyances may involve the transfer of all or part of the rights and responsibilities of operating a property. Similarly, the transfer may be of a non-operating interest to another party with full retention of the property's operation.

SFAS 19 requires that a gain or loss should not be recognized at the time of conveyance when:

- Assets used in oil- and gas-producing activities (including both proved and unproved properties) are transferred in exchange for other assets also used in oil and gas production. If proved properties are transferred in exchange for others also used in gas- and oil-producing activities, and if an impairment loss is found, the guidance of SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, must be followed regarding its recognition in

accounting.

- Assets in a joint undertaking are jointly pooled with the intention of finding, developing, or producing oil or gas from a particular property or group of properties.

SFAS 19 also requires that a gain not be recognized at the time of conveyance when:

- A part of an interest owned is sold and substantial uncertainty exists about the recovery of costs applicable to the retained interests.
- A part of an interest owned is sold and the seller has a substantial obligation for future performance (e.g., obligation to drill a well or operate the property without reimbursement for the portion of drilling or costs to the interest that was sold).

If a conveyance is not classified as one of the transactions described in the aforementioned sections, then a gain or loss would ordinarily be recognized unless other aspects of the transaction would prohibit such recognition under GAAP.

Accounting for income taxes Oil- and gas-producing companies are required to follow SFAS 109, *Accounting for Income Taxes*. These entities incur many transactions (e.g., intangible drilling and development costs that are deductible in determining taxable income when incurred but are capitalized and amortized for financial accounting purposes for successful exploratory wells and development wells) that enter into the determination of taxable income and pretax accounting income in different periods. These transactions generate temporary differences that result in deferred income taxes consequences. In applying SFAS 109 to the gas and oil industry, the possibility that statutory depletion in future periods will reduce or eliminate taxable income in future years should be considered. This is important in determining the likelihood that the tax benefits of deferred tax assets will be realized. However, the tax benefit of the excess of statutory depletion over cost depletion for tax purposes should not be recognized until the period in which the excess is deducted for income tax purposes.

Capitalizing interest costs under the full cost method For oil- and gas-producing operations accounted for by the full cost method, assets that are in use in the earnings process of the entity do not qualify for capitalization of interest cost. Unusually significant investments in unproved properties and major development projects that are not currently being used (and as a result are not being depreciated, depleted, or amortized) and on which exploration or development activities are in progress qualify for capitalization of interest costs. In addition, a cost center with no production, significant properties, and projects on which exploration or development activities are in progress represents assets qualifying for capitalization of interest costs.

Required Disclosures All oil- and gas-producing enterprises must disclose in their financial statements the method of accounting for costs incurred in their oil- and

gas-producing activities and the manner of disposing of capitalized costs relating to those activities.

For purposes of this section, an entity is considered to have *significant* oil- and gas-producing activities if it satisfies one or more of the following criteria:

- Revenues from oil- and gas-producing activities are 10% or more of the combined revenues of all of the entity's industry segments.
- The results of operations for oil and gas activities, excluding income taxes, are 10% or more of the greater of:
 - The combined operating profit of all industry segments that did not incur an operating loss.
 - The combined operating loss of all industry segments that did incur an operating loss.
- The identifiable assets relating to oil and gas activities are 10% or more of the combined identifiable assets of the enterprise, excluding assets used exclusively for general corporate purposes.

This determination should be applied separately for each year for which a complete set of annual financial statements are presented (e.g., a statement of financial position, an income statement, and statement of cash flows including necessary footnotes).

The aforementioned disclosures are required only for complete sets of annual financial statements; they are not required in interim financial reports. Interim financial reports should, however, include information about a major discovery or other favorable or adverse events that cause a significant change from the information relating to oil and gas reserve quantities presented in the most recent annual financial report issued.

Publicly traded entities that have significant oil- and gas-producing activities are required to disclose with their complete sets of annual financial statements the following information, which is considered to be of a supplementary nature:

- Proved oil and gas reserve quantities.
- Capitalized costs relating to oil- and gas-producing activities.
- Costs incurred for property acquisition, exploration, and development activities.
- Results of operations for oil- and gas-producing activities.
- A standardized measure of discounted future net cash flows relating proved oil and gas reserve quantities.

Details relating to these categories are discussed next.

Disclosures relating to proved oil and gas reserve quantities Publicly traded entities that have significant oil and gas production activities are required to disclose the following supplemental information relating to proved oil and gas quantities:

- Net quantities of the entity's interests in proved reserves and proved developed reserves of crude oil (including condensate and natural gas liquids and natural gas. Net quantities should include reserves relating to royalty interests owned if the necessary information is available to the entity. If this information is unavailable, that fact and the entity's share of oil and gas produced for those royalty interests should be disclosed for the year. Net quantities should not include interests of others in properties owned by the entity.
- Changes in net quantities or an entity's proved reserves of oil and gas. The following should be disclosed with an explanation:
 - Revisions of previous estimates either upward or downward resulting from new information derived from development drilling.
 - Changes in reserve estimates resulting from the application of improved recovery techniques.
 - Purchases of minerals in place.
 - Additions to proved reserves that result from (1) extension of proved acreage through additional drilling in periods subsequent to discovery and (2) discovery of new fields with proved reserves.
 - Production.
 - Sales of minerals in place.
- The fact that an entity's proved reserves of oil and gas are located entirely within its home country. If some or all of its reserves are located in foreign countries, appropriate disclosures relating to the net quantities of reserves of oil and gas and their changes should be made for the home country as well as for each foreign geographic area in which material reserves are located.
- Quantities of oil and natural gas liquid reserves and any changes in them should be disclosed in barrels and cubic feet, respectively.
- Important economic consideration or significant uncertainties affecting an entity's proved reserves should be disclosed. Examples are unusually expensive development or lifting costs, and the necessity of building major pipeline or other major facilities before reserve production could begin.
- If a government restricts disclosure of estimated reserves for properties under its authority or of amounts under long-term supply or purchase agreements, or if the government requires the disclosure of reserves other than proved, then the entity should represent that the reserves estimates or amounts do not include figures for that government or that estimates of proved reserves that are disclosed include reserves other than proved.

Disclosures relating to capitalized costs of oil- and gas-producing activities An entity must disclose the aggregate capitalized cost relating to its oil- and gas-producing activities as well as the aggregate related accumulated depreciation, depletion, amortization, and valuation allowances at the end of the year. In general, APB Opinion No. 12, *Omnibus Opinion—1967*, requires that balances of major classes of depreciable assets be disclosed by nature or function. Thus, there should be separate disclosure of capitalized costs for mineral interests in properties, wells and related equipment and facilities, support equipment and facilities used in oil- and gas-producing activities, and uncompleted wells, equipment, and facilities. In addition, combinations of these categories may be appropriate.

If material, capitalized costs of unproved properties should also be disclosed. If the entity's financial statements include investments that are accounted for by the equity method, the entity's share of the investees' net capitalized costs relating to oil- and gas-producing activities as of the end of the year should be shown separately.

Disclosures relating to oil and gas property acquisition, exploration, and development activities Information relating to property acquisition costs, exploration costs, and development costs (whether they are capitalized or charged to expense at the time incurred) are required supplemental disclosures of publicly traded entities that have significant oil and gas production activities.

If some or all of those costs are incurred in foreign countries, the amounts disclosed should be shown separately for each of the geographic areas for which reserve quantities are shown. Significant costs incurred to acquire mineral interests containing proved reserves should be disclosed separately from the costs of acquiring unproved properties.

If the entity accounts for investments using the equity method, the entity's share of the investees' property acquisition, exploration, and development costs should be separately disclosed for the year, in the aggregate, and for each geographical area for which reserve quantities are disclosed.

Presentation of results of operations for oil- and gas-producing activities Information relating to the results of operations for oil- and gas producing activities of an entity should be disclosed for the year. This information should be shown in the aggregate and for each geographic area for which reserve quantities are disclosed. Information relating to the following areas should be presented:

- Revenues.
- Production (lifting) costs.
- Exploration expenses. (It is important to note that entities using the full cost method of accounting generally do not have exploration expenses. Exploration costs incurred using the full cost method of accounting must be capitalized when incurred and therefore are presented in earnings in the form of depreciation, depletion, amortization, and valuation provisions. Usually, only entities that disclose exploration expenses are those that utilize the successful efforts method.)

- Depreciation, depletion, and amortization, and valuation provisions.
- Income tax expense.
- Results of operations for oil- and gas-producing activities (excluding corporate overhead and interest costs).

Disclosure of a standardized measure of discounted future net cash flows related to proved oil and gas reserve quantities

Information relating to a standardized measure of discounted future net cash flows regarding an entity's interest's in (1) proved oil and gas reserves and (2) oil and gas subject to purchase under long-term supply, purchase, or similar agreements and contracts in which the entity participates in the operation of the properties should be disclosed at the end of the period as part of the supplemental disclosures requirement for publicly traded entities that have significant oil and gas production activities. The following information should be shown in the aggregate and for each geographic area for which quantities are disclosed:

- *Future cash inflows*—Future cash inflows should be computed by applying year-end prices of oil and gas relating the entity's proved reserves to the year-end quantities of those reserves. Future price changes should only be considered to the extent provided by contractual arrangements in existence at year-end.
- *Future development and production costs*—Future development and production costs should be computed by estimating the expenditures to be incurred in developing and producing the proved oil and gas reserves at the end of the period based on year-end costs and assuming the continuation of existing economic conditions. If estimated development expenditures are significant, they should be disclosed separately from estimated production costs.
- *Future income taxes*—Future income taxes are derived by applying the appropriate year-end statutory tax rates to the future pretax net cash flows relating to the entity's proved oil and gas reserves less the tax basis of the properties involved.
- *Future net cash flows*—Future net cash flows are determined by subtracting future development production costs and future income tax expense from future cash inflows.
- *Discount*—The discount amount is derived by using a discount rate of 10% a year to reflect the timing of future net cash flows relating to proved oil and gas reserves.
- *Standardized measure of discounted future net cash flows*—This measure is determined by subtracting future net cash flows less the computed discount.

- *The aggregate change in the standardized measure of discounted cash flow—*
The following sources of change relating to this measure should be disclosed separately if individually significant:
 - Net change in sales and transfer prices and in production (lifting) costs related to future production.
 - Changes in estimated future development costs.
 - Sales and transfers of oil and gas produced during the period.
 - Net change due to extensions, discoveries, and improved recovery.
 - Net change due to purchases and sales of minerals in place.
 - Net change to revisions in quantity estimates.
 - Previously estimated development costs incurred during the period.
 - Accretion of discount.
 - Net change in income taxes.

In computing the aforementioned nine amounts, the following guidelines should be followed:

- The effects of changes in prices and costs should be computed before the effects of changes in quantities. As a result, changes in quantities should be stated at year-end prices and costs.
 - The change in computed income taxes should reflect the effect of income taxes incurred during the period as well as the change in future income tax expenses.
 - All changes except income taxes should be reported on a pretax basis.
- Any additional information that must be provided in preventing the disclosure of the standardized discounted cash flow from being misleading should be included.

CHAPTER 17

RECORD AND MUSIC INDUSTRY

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Describe accounting by the licensor and licensee.
- Explain the requirements that should be satisfied in order to recognize revenue.
- Account for royalty payments to artists.
- Determine the costs of recording the master.

TERMINOLOGY

Advance royalty. An amount paid to music publishers, record producers, songwriters, or other artists in advance of their earning royalties from record or music sales. Such an amount is based on contractual terms and is generally nonrefundable.

License agreements. Contractual arrangements entered into by an owner (licensor) of a record master or music copyright with a licensee granting the licensee the right to sell or distribute records or music for a fixed fee paid to the licensor or for a fee based on sales of records or music. License agreements are modifications of the compulsory provisions of the copyright law.

Minimum guarantee. An amount paid in advance by a licensee to a licensor for the right to sell or distribute records or music.

Record master. The master tape resulting from the performance of the artist. It is used to produce molds for commercial record production and other tapes for use in making cartridges, cassettes, and reel tapes.

Royalties. Amounts paid to record producers, songwriters, or other artists for their participation in making records and to music publishers for their copyright interest in music. Amounts for artists are determined by the terms of personal service contracts negotiated between the artists and record companies and usually are determined based upon a percentage of sales activity and license fee income, adjusted for estimated sales returns. Royalties for publishing are based on the copyright or other applicable laws, but the requirements of the law may be modified by licenses issued by the publishers.

SOURCES OF GAAP

The key source of authoritative GAAP relating to guidance in the record and music industry is:

- SFAS 50, *Financial Reporting in the Record and Music Industry*.

RULES, CONCEPTS, AND ILLUSTRATIONS

SFAS 50 discusses the standards of financial accounting and reporting for licensors and licensees in the record and music industry. A licensor of a music copyright or the owner of a record master should recognize license fees as revenue if a license agreement is, in substance, an outright sale and collectibility of the licensing fees is reasonably assured. A licensee, paying minimum guarantees to a licensor, should record them as assets and charge them to expense in accordance with the terms of the license agreement. Compensation paid to artists in the form of royalties should be adjusted for anticipated returns and charged to expense in the period in which the sale of the recording takes place.

KEY GAAP

Accounting for Licensors

An entity may generate a significant amount of revenue by licensing the rights of ownership in a record master or music copyright. A record master is the master tape of the performance of an artist. It is used to produce the molds used for commercial record production and other CDs and tapes for use in making cartridges, cassettes, and reel tapes. In a licensing agreement, the licensor (owner of a record master or music copyright) grants the licensee the right to sell or distribute records or music for a fixed fee (paid to the licensor) or for a fee based on the sales of records or music. In many instances, a license agreement is, in substance, an outright sale. SFAS 50 requires the earnings process regarding licensing fees relating to such agreements (licensor agreements) to be considered complete and reported as revenue if collectibility of the full fee is reasonably assured and the following criteria relating to the licensor has been met. The licensor must have:

- Signed a noncancelable contract.
- Agreed to a fixed fee.
- Delivered the rights to the licensee who is free to exercise them.
- In addition, there must be no remaining significant obligations to furnish music or records.

A minimum guarantee is commonly paid by a licensee. The licensor should report such a payment as a liability initially and recognize the guarantee as revenue as the license fee is earned. If the amount of license fee earned cannot be ascertained, the guarantee should be recognized equally over the remaining period of the license agreement. Other fees (such as free records distributed by a record club in excess of a predetermined amount) that are required by a license agreement and are not fixed in amount prior to the expiration date of the agreement should be recognized as revenue only when reasonable estimates of such amounts can be made or when the agreement has expired.

Compensation to Artists

Royalties earned by recording artists should be adjusted for anticipated returns and charged to expense in the period in which the sale of the recording takes place. If an advance royalty is paid to an artist, it should be reported as an asset if the artist's current popularity and past performance provide a valid basis for estimating the amount of the advance that will be recoverable from future royalties to be earned by the artist. Advances should be charged to expense as subsequent royalties are earned by the artist. If it appears that a portion of future

royalties is not recoverable from future royalties to be earned by the artist, such portion should be charged to expense in the period in which the loss becomes apparent. Advance royalties should be classified as either current or noncurrent assets.

Cost of Record Masters Incurred by a Record Company

Costs for record masters incurred by a record company should be reported as an asset if the current popularity and past performance of the artist indicate a sound basis for estimating the recovery of cost from future sales. If not, the cost should be expensed. Costs that are recognized as assets should be amortized over the estimated life of the recorded performance using a method that reasonably matches the amount of net revenue to be realized.

The part of the cost of record masters (incurred by the record company) that is recoverable from the royalties of an artist should be accounted for as an advance royalty, as discussed in the section on compensation to artists.

Accounting by Licensees

Minimum guarantees are commonly paid in advance by a licensee. This amount should be reported by a licensee as an asset and subsequently charged to expense. If all or a portion of the recorded guarantee appears not to be recoverable through the future use of rights derived from the license, then that amount deemed unrecoverable should be charged to expense. Any other fees that must be paid (e.g., free records distributed by a record club in excess of a predetermined amount) that are not fixed in amount prior to the expiration date of the license agreement should be estimated and accrued by the licensee on a license-by-license basis.

Disclosure Requirements

SFAS 50 requires that the following be disclosed by a record entity:

1. Commitments for artist advances that are payable in future years and future royalty guarantees.
2. The recorded cost of record masters incurred by the record company that are recorded as assets.

CHAPTER 18

REAL ESTATE TRANSACTIONS

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Describe profit recognition for sale of real estate by the full accrual and other methods
- Distinguish between retail land sales and other sales of real estate.
- Account for retail land sales—Use of the full accrual method, percentage of completion method, installment method, deposit method, and disclosure requirements.

TERMINOLOGY

Retail land sales. Large amounts of residential lot sales of subdivisions of large tracts of land.

SOURCES OF GAAP

The key sources of authoritative GAAP relating to real estate transactions include:

- SFAS 66 (*Accounting for Sales of Real Estate*).
- SFAS 98 (*Accounting for Leases*).
- SFAS 140 (*Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*).
- SFAS 144 (*Accounting for the Impairment for Disposal of Long-Lived Assets*).
- FASB Interpretation No. 43 (*Real Estate Sales*).
- SFAS 67 (*Accounting for Costs and Initial Rental Operations of Real Estate Projects*).
- Issue No. 84 –17 (*Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages*).
- Issue No. 84 –37 (*Sale-Leaseback Transaction with Repurchase Option*).
- Issue No. 85–27 (*Recognition of Receipts from Made-up Rental Shortfalls*).
- Issue No. 86 – 6 (*Antispeculation Clauses in Real Estate Sales Contracts*).
- Issue No. 86 –7 (*Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts*).
- Issue No. 86 –17 (*Deferred Profit on Sale-Leaseback Transaction with Lessee Guarantee of Residual Value*).
- Issue No. 87–9 (*Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds*).
- Issue No. 88–12 (*Transfer of Ownership Interest as Part of Down Payment under SFAS Statement Number 66*).
- Issue No. 88–14 (*Settlement of Fees with Extra Units to a General Partner in*

a Master Limited Partnership).

- Issue No. 88–21 (*Accounting for the Sale of Property Subject to the Seller's Preexisting Lease*).
- Issue No. 88–24 (*Effect of Various Forms of Financing under SFAS Statement Number 66*).
- Issue No. 89–14 (*Valuation of Repossessed Real Estate*)
- Issue No. 98– 8 (*Accounting for Transfers of Investments that are in Substance Real Estate*).
- Issue No. 00–11 (*Meeting the Ownership Transfer Requirement of SFAS 13 for Leases of Real Estate*).
- Issue No. 00–13 (*Determining Whether Equipment Is 'Integral Equipment' Subject to SFAS Number 66 and Number 98*).
- Issue No. 01–2 (*Implementation of APB Number 29*).

RULES, CONCEPTS, AND ILLUSTRATIONS

GAAP distinguishes between retail land sales and real estate sales other than retail land sales. Under the full accrual method of accounting for land sales, the following must be satisfied before profits may be recognized.

- The seller's receivables from the land sales must be collectible. Thus, the profit on the sales is determinable.
- The earnings process is deemed complete because the seller has no significant remaining obligations for construction or development.

Retail land sales not accounted for by the full accrual method should be accounted for and reported using the percentage-of-completion or the installment method. The criteria for their applicability are based on the collectibility of the seller's receivable from the land sales and the seller's remaining obligations.

Profit recognition for other sales of real estate by the full accrual and several other methods is all delineated in the subsequent discussions. This recognition is dependent on whether a sale has been consummated, the degree of the buyer's investment in the property being sold, whether the sellers' receivable is subject to future subordination, and the extent of the seller's continuing involvement with the property after the sale.

KEY GAAP

This section enumerates the standards for recognition of profit on all real estate sales transactions, including real estate with property improvements and integral equipment, without regard to the nature of the seller's business. Property improvements and integral equipment refer to any physical structures or equipment attached to the real estate that cannot be removed and used separately without incurring significant costs (e.g., an office building, a manufacturing facility, a power plant, timberlands or farms [land with trees or crops attached to it]). Natural assets that have been extracted from the land, such as soil, gas, and coal, are excluded from this guidance. The following transactions are also excluded from this guidance:

- The sale of the net assets or stock of a subsidiary or component of an entity if the assets of that subsidiary or that component, as applicable, contain real estate, unless the transaction is, in substance, the sale of real estate.
- The sale of securities that are accounted for in accordance with SFAS No. 115, *Accounting for Certain Investments and Equity Securities*, and related guidance.
- The sale of property improvements or integral equipment only without the sale of the underlying land.

The provisions of GAAP in this area distinguish between retail land sales and real estate sales other than retail land sales. SFAS 66 notes that the former are sales, on a volume basis, of lots that are subdivisions of large tracts of land. They are characterized by (1) very small down payments; (2) the inability of the seller to enforce the sales contract or the buyer's note against the buyer's general credit; (3) return of the buyer's down payment if the cancellation is made within an established cancellation period; and (4) defaults by the buyer after the cancellation, resulting in recovery of the land by the seller and forfeiture of at least some of the principal payments by the buyer. Amounts retained by the seller are determined by federal and state laws.

Examples of real estate sales transactions that are not retail land

- Sales of lots to builders.
- Sales of homes, buildings, and parcels of land to builders and others.
- Sales of corporate stock of enterprises with substantial real estate.
- Sales of a partnership interest that is in substance a sale of real estate (for example, an enterprise that forms a partnership, arranging for the partnership to acquire the property directly from third parties, and selling an interest in the partnership to investors, who then become limited partners).
- Sales of time-sharing interests if the sales are in-substance sales of real estate (time-sharing real estate interests represent the right to occupy a dwelling for a designated period each year).

Real Estate Sales Other than Retail Land Sales

Sales of real estate other than retail land sales may be accounted for using one of the following methods:

- *Full accrual method*—Profit is recognized when the real estate is complete and a sale has been completed.
- *Cost recovery method*—Profit recognition is deferred until cash received exceed the seller's cost of the property sold.
- *Deposit method*—No recognition of profit at consummation of the sale.
- *Reduced profit method*—Profit is deferred until payments are made.
- *Percentage-of-completion method*—The amount of profit recognition is predicated on the relationship of costs incurred to the total costs to be incurred.

- *Installment method*—Payments represent cost recovery and profit recognition.

A discussion of these methodologies follows.

Use of the full accrual method The full accrual method should be used if:

- The sale has been fully consummated. A sale has been fully consummated when:
 - All consideration specified in the contract has been exchanged.
 - The parties to the contract are fully bound by the contract.
 - All requirements that had to be satisfied to close the sale of property have been satisfied (e.g., inspections, land surveys, title policies).
 - Any permanent financing that is required of the seller has been arranged.
- The buyer's initial and continuing investments in the property are considered sufficient commitments to pay for the property. A purchaser's initial investment should include:
 - Any cash that was paid as a down payment.
 - The purchaser's notes payable to the seller together with irrevocable letters of credit from established lending institutions.
 - Any payments by the buyer to third parties to reduce any existing debt that may remain on the property.
 - Additional cash proceeds that were paid by the buyer as a required part of the sales contract (e.g., points, prepaid interest).
 - Any other payments or considerations that have been sold or converted to cash to the seller.

The initial investment in the property is considered to be met by SFAS 66 for purposes of sufficiency if it is at least equivalent to that which an independent lending institution would require for a loan on the same type of property at the same price. For example, the following are some examples of the minimum initial investments expressed as a percentage of sales value that would have to be paid in to satisfy SFAS 66:

<i>Property</i>	<i>Percentage of Sales to be Paid In</i>
Land—Held for commercial, industrial, or residential development to commence within two years after sale	20
Held for commercial, industrial, residential, development to commence after two years	25

Multifamily residence:

Primary residence:

Cash flow currently sufficient to service all indebtedness	1
	0

Start-up situations or current deficiencies in cash flow	1
	5

Secondary or recreational residence:

Cash flow currently sufficient to service all indebtedness	1
	5

Start-up situations or current deficiencies in cash flow	2
	5

Single-family residential property (including condominium or cooperative housing)

Primary residence of the buyer	5
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Secondary or recreational residence	1
	0

Note: Minimum initial investments for other types of property are specified in paragraph 54 of SFAS 66.

Frequently, sales contracts relating to land sales contain certain provisions that require a seller to release a lien on a portion of property after receiving certain amounts of payments from the seller. The seller will release the lien only if it has obtained a sufficient amount of money that it believes places an acceptable level of risk on the remaining financing. In this situation, the initial investment of the buyer is considered to be sufficient for the property overall if (1) it is an adequate initial investment on the property not released and (2) it is considered adequate to cover the property released at the date of sale. If the amounts applied to the unreleased portions do not satisfy the initial (and continuing) investment requirements, each release should be viewed as a separate and individual sale.

- The sale is not subject to future subordination. The seller's receivable should have a lien that is not subordinate to all other debt in the property except (1) a first mortgage loan existing at the date of sale or (2) a future loan provided for in the sales agreement assuming that any proceeds for loan repayment will be applied first to the receivable of the seller.
- The sale of the property fully constitutes a transfer of all the risks and rewards of property ownership without any future seller involvement in the property. The fact that the seller has some sort of involvement may be indicative of the fact that the risks and rewards of property ownership have not, in fact, been transferred and a bona fide sale has not been made. For example, the seller may guarantee the buyer some purchase price rebate if a minimum return is not generated for the new buyer.

Additional requirements must also be met in order for a retail land sale to be accounted for under the full accrual method. SFAS 66 requires that the following must also

be met:

- Development of the lots that have been sold must be complete.
- The refund period has expired.
- Cumulative payments are sufficient.
- Receivables are subordinate to any debt on the property and are deemed to be fully collectible.

If these criteria are not met, revenue should be recognized under the percentage-of-completion method, installment method, or deposit method.

EXAMPLE: FULL ACCRUAL METHOD

A company that develops land lots enters into a sales agreement with a contractor to purchase the land lots for \$600,000. The agreement calls for the contractor to pay the development company \$150,000 cash and a note for \$450,000. The note is due in four equal installments, pays interest at the rate of 8%, is not subordinate to any new loans on the property, and is backed by an irrevocable letters of credit from an independent established lending institution. Land and development costs on the part of the development company equal \$400,000. The land development company would make the following entry on the sale of the developed lots:

Cash	150,000	
Note receivable	450,000	
Sales from lots		600,000
Cost of lots	400,000	
Land and development capitalized costs		400,000

The full accrual method should be used when the aforementioned noted criteria have been met. If they have not been met, the method of accounting that should be used depends on the criteria that have not been met. The following is a discussion of the methods that should be used when certain of the criteria have not been met.

Nonconsummation of the sale If the real estate sale has not been consummated, the seller should use the deposit method of accounting. However, when office buildings, apartments, condominiums, shopping centers, and similar structures are being built, the percentage-of-completion method may be used because of the relatively long construction period.

Buyer's initial investment is insufficient and does not qualify If the buyer's initial investment is insufficient but recovery of the cost of the property is reasonably assured in the contingency of a default by the buyer, the sale should be accounted for using the installment method. However, if the recovery of the property's cost is uncertain (the receipt of the full sales price of the property is uncertain), the cost recovery method should be used.

It is possible for the seller of the property that has accounted for the sale under the installment method or cost recovery method to subsequently change to the full accrual method if the requirements for the full accrual method are satisfied. The accounting for the change consists of recognizing in income the remaining profit that had not been recognized under the installment or cost recovery method.

Buyer's continuing investment is insufficient for the full accrual method and does not qualify

If the purchaser's initial investment is sufficient to satisfy the full accrual method, but it is not sufficient to recognize profit under that method because the continuing investment is not sufficient, the seller should use the reduced profit method, installment method, or cost recovery method. The reduced profit method should be used when the purchaser's annual payments made to the seller are large enough to cover (1) principal and interest on the maximum first mortgage loan that could be obtained on the property and (2) interest, at the market rates, on the excess of the actual total debt on the property over such a maximum first mortgage loan. If these criteria are not both met, the seller should recognize profit by either the installment method or the cost recovery method.

Receivable accepted by the seller subject to future subordination If the seller receivable is subject to future subordination, its recoverability is not assured, because the seller would not have an unequivocal right to the property if the buyer defaults. In this situation, the seller should use the cost recovery method when its receivable is subject to future subordination, except when (1) a first mortgage loan exists on the date of the sale or (2) a future loan provided for in the sales agreement if the loan proceeds will be applied first to pay the seller's receivable.

Seller's continuing involvement exists after property is sold If the transfer of the risks and rewards of ownership to the purchaser has not occurred because the seller still maintains a continuing involvement with the property, the full accrual method of accounting should not be used. If the seller's loss of profit because of his or her continuing involvement with the property is limited by the terms of the sales contract, profit may be recognized but should be reduced by the seller's maximum exposure to loss. In all other situations, if the seller has some other form of continuing involvement with the property, the transaction should be accounted for in accordance with the extent nature of the seller's involvement rather than as a sale (e.g., profit sharing, financing, leasing).

A brief discussion follows of different forms of continuing involvement with the property and the accounting methods that should be used:

- The seller has partially sold the property. Partial sales consist of those in which the seller maintains an ownership interest in the property or has an ownership interest in the buyer. In this situation, profit should be recognized only when:
 - The buyer and seller are independent of each other. If the seller has a noncontrolling interest in the buyer, the seller should recognize profit in proportion to the outside ownership of the purchaser. However, if the

seller has a controlling interest in the buyer, no profit should be recorded until it is realized by a sale to an independent party or by profits from continuing operations.

- The sales price is reasonably assured of being collectible. If the sale is not reasonably assured, the installment method or cost recovery method should be used.
 - The seller is not obligated to support the operations of the property or its obligations to an extent greater than its ownership interest. If, in fact, the seller has to support the operations of the property or its obligations and the transaction is in substance a sale, the seller should record profit to the extent that the proceeds from the sale exceed all the costs related to the property that are the responsibility of the seller.
- The seller is required to repurchase the property, or the contract contains an option that may be exercised by the buyer requiring that the seller repurchase the property. In substance, therefore, this transaction should be accounted for as a financing, leasing, or profit-sharing contract rather than a sale of real property.
- The seller is required to support the operations of the property. If the degree of support provided by the seller is only for a limited amount of time, profit on the sale should be recognized on the basis of the services performed. This assumes, however, that profit should not be recognized until there is reasonable assurance that future receipts will exceed operating expenses, debt payments, and other contractual obligations. On the other hand, if the seller is required to support operations for an extended period of time, the transaction should be accounted for as a financing, leasing, or profit-sharing agreement rather than a sale. If the support period is not specified in the sales contract, it is presumed for at least two years beyond the date that rental operations begin. Revenue should be recognized on the degree of performance of the seller in this situation. If actual rental proceeds exceed operating expenses, debt service, and other contractual payments before the two-year period ends, profit may be recognized at an earlier date. If the sales agreement requires that the seller manage the property without any compensation at all or less than the going rates expected for such services, compensation should be estimated as income as the services are performed over the contract term when the sale is recognized.
- The seller is a general partner in a limited partnership that has acquired an interest in the property and the seller holds a receivable from the buyer for a material portion of the sales price. In this situation, the transaction should be accounted for as a financing, leasing, or profit-sharing agreement rather than a sale of property.
- The seller leases back all or a part of the property for the remaining life of the property. This transaction should be accounted for as a financing, leasing, or

profit-sharing arrangement rather than a sale.

- The seller contractually guarantees a return of the buyer's investment in the property or guarantees some return on the investment for an extended period of time. The transaction is a financing, leasing, or profit-sharing arrangement rather than a sale. Note: If the guarantee of investment return is for a limited period of time, the deposit method of accounting should be used until operations of the property cover the operating expenses, debt service, and contractual payments. Profit should only be recognized subsequently when required services are performed.
- On sales of condominiums or time-sharing interests, profits should be recognized based on the percentage-of-completion method. The percentage-of-completion method should be used on the sale of individual units (of condominium units or time sharing interests) if the following criteria are met:
 - The buyer can no longer require a refund (except for nondelivery of the unit or interest).
 - Construction is beyond the preliminary stage.
 - Sales prices are deemed to be collectible.
 - Enough units of the building project have been sold so that it may be assumed that the project will not become a rental property.
 - Total sales revenues and costs can be reasonably estimated.

If any of the aforementioned criteria were not met, the deposit method should be used. When all are met, the percentage-of completion method should be used.

- Although the form of the agreement appears to be a sale, the purchaser of the property has an option to buy the property. In this situation, generally, the buyer makes a down payment and is not required to make any more payments on the property until certain conditions are resolved, such as obtaining a building permit or zoning modification. These transactions should be accounted for using the deposit method, and the funds from the sale are accounted for as a liability and recognized as income when the purchaser exercises the option or allows it to expire.
- The seller sells building improvements and leases the land underlying the improvements to the buyer. In this situation, the entire transaction is accounted for as a lease if the land lease does not cover the entire economic life of the improvements or is not for a substantial period. If both of these criteria are met, profit should be recognized on the sale of the improvements at the time of the sale and measured by (1) the present value of the lease rental payments (not in excess of the cost of the land) plus (2) the sales value of the improvements less (3) the carrying value of the improvements and the land.

The seller should record profit on the buyer's rent payments that are made if they exceed the land's cost and the rent is received after the primary debt on the improvements is paid off. The profits should be recognized when:

- The land is sold, or
 - The rents in excess of the seller's cost of the land are earned under the lease.
- The sales contract requires that the seller is obligated to develop the property in the future. In this case, if such obligation exists, or the seller is required to extend the facilities in any way, the percentage-of-completion method is commonly used to account for the sale.
- The sales agreement calls for the seller to partake in the future profits of the property without the risk of any loss. In general, if this transaction qualifies for the full accrual method of accounting and the seller partakes in future profits in the property without risk of loss, then the risks and rewards of ownership and the lack of continuing involvement are considered to be met. Future profit is recorded in the accounting period when the profits are in fact realized. All costs of the sale are recognized at the time of the sale. Specifically, no costs are deferred to periods when contingent profits are realized.

Retail Land Sales

Retail land sales consist of large amounts of residential lot sales of subdivisions of large tracts of land. The developer of the land attempts to provide the buyer with financing terms that require a lower down payment than would be possible if the buyer would attempt to obtain the financing from outside financial institutions. In the latter situation, for example, financial institutions would require that buyer's note be purchased only at a significant discount. In general, the land developer is also required to provide the buyer with a refund period in which a full refund would be received and the sales contract would be considered null and void.

FASB 66 requires that a single method be used to recognize profit from all sales transactions within a retail land sales project. However, when certain conditions change for the entire project, the method of recognizing profit should be changed to reflect the new conditions.

Accounting for retail land sales The following is a discussion of the methods used to account for profits from retail land sales:

- *Full accrual method.* SFAS 66 requires that the full accrual method of accounting be applied to a retail land sale if all of the following conditions are met:
1. The period of cancellation with refund has expired.
 2. Cumulative payments equal or exceed 10% of the contract sales price.

3. The receivables are collectible.
4. The receivables are not subject to subordination.
5. The development is complete.

A down payment of at least 20% is considered an acceptable indication of the collectibility of receivables. Because all other conditions are met, the full accrual method should be used if the development has been completed.

In accounting for the full accrual method, sales must be recognized at the amount contracted for, an allowance of doubtful collectibles must be provided for, the cost of the lots that are sold must be transferred from the seller's inventory account, and an allowance for discounts (contra contracts receivable account) must be recorded to reduce the receivable account to the present value of all required payments. If the seller has initiated programs that are designed to accelerate the collection of receivables, any profit on the sale should be reduced by the charges for anticipated discounts being offered as a result of incentives. Sales discounts as a result of infrequently offered incentives should be debited against income in the period in which they are granted.

- *Percentage-of-completion method.* For a retail land sale that satisfies all the conditions for the accrual method except that the seller has not met its obligation to complete all improvements or construction on the lots that are sold, the percentage-of-completion method should be used if the two following conditions are met:
 - It is believed that the land can be developed for the purposes expected and that the properties can be used for these purposes at the end of the expected payment period.
 - The improvements and construction that are required on the property have been initiated and are in progress. There is every reason to believe, based on the work that has already been performed, that all improvements and construction will be completed according to the agreed-upon plan. There do not appear to be any extenuating circumstances, such as delays or additional costs, that would mean the project will not be completed as expected.

Accounting for the percentage-of-completion method is as one would expect. Revenue should be recorded by computing the ratio of costs incurred to date to the total estimated costs expected to be incurred. This fraction is then multiplied by the net sales number. Costs incurred and total cost to be incurred include the following: land cost, interest and project carrying costs incurred prior to the sale (previously charged to expense), and selling costs associated with the project. Estimates for future improvement costs should be based on amounts that are expected in the construction industry in the area. Estimates of future improvements should be reviewed yearly and the percentage-of-completion should be recalculated when cost estimates are revised.

- *Installment Method.* If a retail land sale has gone beyond its refund period,

has had its cumulative payments equal no less than 10% of the full contract price, and does not meet any of the other criteria for the full accrual method or percentage-of-completion methods, it should be accounted for under the installment method if the following two conditions are met regarding the financial condition of the seller:

- The seller is able to provide both land improvement and any offsite construction that was committed to in the contract.
- The seller is satisfying all other commitments made in the contract, including ensuring the completion of the improvements of the project.

A seller originally accounting for a retail land sale by the installment method may adopt the percentage-of-completion method if the land sale subsequently satisfies all the conditions required of this method. In this situation, the seller may utilize the percentage-of-completion method for the whole project (both prior and current sales) and account for the change in methodology as a change in accounting estimate.

- *Deposit Method.* A retail land sale that fails to satisfy the conditions required for the full accrual method, percentage-of-completion method, and the installment method should be accounted for under the deposit method.

Disclosure Requirements

Real estate transactions—other than retail land sales. Following are the disclosure requirements for some of the methods of accounting for real estate transactions as prescribed by SFAS 66:

Installment method—Under this method, the income statement (or notes) in the period of the sale should disclose the sales value, the deferred gross profit, and the total cost of the sale. Revenue and the cost of the sales should be shown as separate items on the income statement or should be shown in the notes when the profit is recognized. Under the installment method, gross profit recognized during each period of the term of an installment receivable is equal to the gross profit ratio on the installment sales for the period in which the receivable was recognized, multiplied by the cash collected on that receivable during the period. Hence, gross profit is recognized in proportion to the cash collections received.

Cost recovery method—Under this method, the income statement for the period including the sales date should disclose the sales value, the deferred gross profit, and the total cost of the sale. The gross profit that has not yet been recognized should be offset against the related receivable on the balance sheet. Gross profit should be presented as a separate revenue item on the income statement when it is recognized.

Deposit method—Under this method, the nonrecourse debt that has been assumed

by the purchaser should be disclosed as a liability in the balance sheet of the seller. It should not be offset against the related asset.

Note: When receivables are collected over an extended period and, because of the terms of the transaction or other conditions, no reasonable basis exists for estimating the degree of collectibility, the installment method or the cost-recovery method of accounting may be used for financial statement purposes,.

Retail land sales Following are the disclosure requirements for enterprises involved in retail land sales prescribed by SFAS 66:

- Accounts receivable that mature for each of the five years following the date of the financial statements.
- The weighted average of stated interest rates and range of receivables.
- The balance of delinquent accounts receivable as well as the method used by the seller for determining the delinquency.
- An estimate of the total costs and estimated dates of expenditures for contractual improvements for major areas from which sales are being generated for each of the five years after the date of the balance sheet.
- Recorded debts for contractual improvements that must be made.

Accounting for Costs and Initial Rental Operations of Real Estate Projects

SFAS 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, applies to acquisition, development, construction, selling, and rental costs of such projects.

1. Incremental revenue from incidental operations in excess of incremental costs (e.g., profits from an adjacent golf course) should be accounted for as a reduction of the capitalized project costs. However, incremental costs in excess of incremental revenues should not be capitalized. They should be expensed because the incidental operations did not reduce the cost of developing the property for its intended use.

2. A real estate project should be considered substantially completed and held available for occupancy upon completion of tenant improvements by the developer, but no later than 1 year from the cessation of major construction activity. When the project is substantially complete, costs are expensed as they accrue and previously capitalized costs should be amortized.

According to SFAS 67, preacquisition costs such as payments to obtain an option to acquire real property should be capitalized. Other costs related to real property that are incurred before the enterprise acquires the property should be capitalized if certain conditions are met. The following conditions are required to be met before other preacquisition costs are capitalized.

1. The costs are directly identifiable with a specific property.
2. The costs would be capitalized if the property had already been acquired.
3. Acquisition of an option to acquire the property is probable.

CHAPTER 19

PENSION FUNDS

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Outline the most important goal of the financial statements of a pension plan Fund accounting.
- Discuss accounting and reporting by defined benefit pension plans.

OVERVIEW AND ISSUES

SFAS 35, *Accounting and Reporting by Defined Benefit Pension Plans*, is the principal standard involving the accounting and reporting by private sector defined benefit pension plans. Defined benefit pension plans usually provide pension benefits but may provide death and disability benefits or termination of employment benefits. This statement applies both to plans that are subject to ERISA and those that are not. SFAS 35 applies to ongoing plans, but not to ones that are expected to be terminated and not to government sponsored social security plans. This standard emphasizes aspects of particular importance to pension plans and aspects that differ from existing GAAP for other types of entities.

SFAS 75, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units*, amended SFAS 35 and indefinitely deferred its application to pension plans of state and local government units.

SFAS 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, amended SFAS 95, *Statement of Cash Flows*, and provided that a statement of cash flows was not required for defined benefit pension plans and certain other employee benefit plans that present similar information to that required by SFAS 35.

SFAS 110 amended SFAS 35 to require all investment contracts issued to be reported at fair value. Only contracts that incorporate mortality or morbidity risk should be reported at contract value.

SOURCES OF GAAP

- SFAS 35, *Accounting and Reporting by Defined Benefit Pension Plans*.
- SFAS 75, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units*.
- SFAS 95, *Statement of Cash Flows*.
- SFAS 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*.
- SFAS 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*

RULES, CONCEPTS, AND ILLUSTRATIONS

The most important goal of the financial statements of a pension plan is to communicate information that is relevant in determining the plan's capability to pay benefits. Thus, the statements should report:

1. Plan resources
2. Stewardship responsibilities
3. Participants' accumulated plan benefits
4. Results of transactions and events regarding the resources and benefits
5. Any other significant information that will aid the users in assessing accomplishments or lack thereof

Financial Statements

The plan's annual financial statements should include:

1. A statement of end of the year net assets available
2. A statement of period changes in net assets available
3. Information concerning actuarial present value of accumulated plan benefits (APVAPB) as of either the end or beginning of the plan year
4. Information concerning significant factors affecting the year-to-year changes in the APVAPB

Net assets available and APVAPB should be reported as of the same date and information regarding their changes should be for the same period. End-of-the-year benefit information is preferable.

Net Assets

The accrual basis of accounting is required. Contributions receivable include those due from formal commitments, legal requirements, or contractual requirements. These amounts are due as of the reporting date from plan participants, employers, and other sources.

Investments of the plan are to be reported at fair value. If there is an active market, market price should be used. Otherwise, the selling price of similar investments or discounted cash flows could be useful in estimating fair value. Plan investments should be identified by type of investment and should indicate how fair value was determined.

Insurance company contracts were to be reported in a manner required by ERISA. SFAS 110 amended this provision of SFAS 35 to require investment contracts with an insurance company or other financial institution to be reported at fair value. The effective date was December 31, 1992. Certain contracts entered into prior to March 20, 1992, are reported as before. Restatement is required if prior year financials are presented with statements for plan years beginning after December 15, 1992.

Buildings, equipment, and other fixed assets should be reported at cost less accumulated depreciation or amortization.

Changes in Net Assets

Disclosure of significant changes in net assets should include:

1. Contributions from:
 - a. Employer(s)--indicate cash and noncash
 - b. Participants, including sponsor
 - c. Other identified sources
2. Paid benefits
3. Payments to insurance companies to purchase contracts that are excluded from plan assets
4. Each significant class of investment should show its net appreciation or depreciation in fair value presented by:
 - a. Investments measured by market price in an active market
 - b. Investments measured by some other means
5. Investment income (not including appreciation or depreciation in fair value)
6. Administrative expenses

Actuarial Present Value of Accumulated Plan Benefits (APVAPB)

The provisions of the plan should be used, to the extent possible, to measure the accumulated plan benefits. If the plan is unclear on this aspect, one of two ratios should be used. If the benefit is includable in vested benefits, then the ratio is:

$$\frac{\text{Number of years of service completed to date}}{\text{Number of years of service needed for full vesting}}$$

If the benefit is not includable in vested benefits, then the applicable ratio is:

$$\frac{\text{Number of years of service completed to date}}{\text{Projected number of years of service completed until separation from covered employment}}$$

The following are applicable in the measurement of accumulated plan benefits (APB):

1. APB as of the benefit information date should be based on:
 - a. Pay and service history of employees
 - b. Other significant factors that are relevant
2. In determining expected eligibility for particular benefits, projected years of service may be used
3. If the plan specifies automatic benefit increases, they should be recognized
4. Payments to insurance companies should be excluded if the related contracts to

- provide benefits is excluded from plan assets
5. Amendments to the plan effective after the information date should not be recognized
 6. Employee compensation is assumed not to change beyond the information date for the determination of social security benefits. Wage base increases and benefit level increases should not be recognized

The APVAPB should be separated into the following reporting categories:

1. Vested benefits--participants receiving payments
2. Other vested benefits
3. Nonvested benefits

As of the benefit information date:

1. Category (1) above should include benefits due and payable
2. Employees' accumulated contributions (including interest) should be disclosed
3. Interest rates in (2), if applicable, should be disclosed

Actuarial assumption changes are considered changes in estimates. Significant factors affecting the change of APVAPB during the period should be identified. Such factors include plan amendments, actuarial assumption changes, and plan mergers or spin-offs.

Cash Flow Statement Exemption

SFAS 102 exempted defined benefit pension plans from the requirement that a statement of cash flows be provided. Other employee benefit plans that report similar financial information (including reporting plan investments at fair value) were also exempted. Although exempted, a presentation of a statement of cash flows was encouraged if it would provide useful information about the plan's ability to pay future liabilities.

CHAPTER 20 REGULATED OPERATIONS

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Discuss accounting related to public utilities.
- Account for abandonments and phase-in plans.

OVERVIEW AND ISSUES

Although various businesses are subject to regulatory oversight to greater or lesser degrees, as used in GAAP the term *regulated operations* refers primarily to public utilities, whose ability to set selling prices for the goods or services they offer is constrained by government actions. Generally, the regulatory process has been designed to permit such enterprises to recover the costs they incur, plus a reasonable rate of return to stockholders. However, given the political process of rate setting by regulatory authorities, and the fact that costs such as those for plant construction escalated greatly during the past decade or so, the ability to recover all costs through rate increases has become less certain. For this and other reasons, specialized GAAP has been promulgated.

SOURCES OF GAAP

- SFAS 35, *Accounting for the Effects of Certain Types of Regulation*.
- SFAS 90, *Regulated Enterprises—Accounting for Abandonment and Disallowances of Plant Costs*.
- SFAS 92, *Regulated Enterprises—Accounting for Phase-in Plans*.
- SFAS 98, *Accounting for Leases*
- SFAS 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of SFAS 71*.

RULES, CONCEPTS, AND ILLUSTRATIONS

These accounting principles apply to regulated enterprises only if they continue to meet certain criteria, which relate to the intended ability to recover all costs through the rate setting process. When and if these conditions no longer are met, due to deregulation or a shift to rate setting which is not based on cost recovery, then application of the specialized GAAP is to terminate.

Asset Recognition

If certain costs are not recognized for current rate setting purposes, but it is probable that the costs will be recovered through future revenue, then these costs can be capitalized even though a nonregulated enterprise would be required to expense these costs currently. Deferred costs can include an imputed cost of equity capital, if so accounted for rate setting purposes, even though this would not normally be permitted under GAAP. Thus, the regulatory process can result in the accounting recognition of an asset which would not otherwise be recognized. If at any time it becomes apparent that the incurred cost will not

be recovered through generation of future revenue, that cost should be charged to earnings. If a regulator subsequently excludes specific costs from allowable costs, the carrying value of the asset recognized shall be reduced to the extent of the excluded costs. Should the regulator allow recovery of these previously excluded costs or any additional costs, a new asset shall be recognized and classified as if this costs had been initially included in allowable costs.

Imposition of Liabilities

In other situations, the regulatory process can result in the accounting recognition of a liability. This usually occurs when regulators mandate that refunds be paid to customers, which must be accrued when probable and reasonably estimable, per SFAS 5, *Accounting for Contingencies*. Furthermore, regulatory rates may be set at a higher level, in order to recover costs expected to be incurred in the future, subject to the caveat that such amounts will be refunded to customers if it later becomes apparent that actual costs incurred were less than expected. In such cases, the incremental rate increase related to recovery of future costs must be accounted for as a liability (unearned revenue), until the condition specified is satisfied. Finally, regulators may stipulate that a gain realized by the utility will be returned to customers over a specified future period; this will be accounted for by accrual of a liability rather than by recognition of the gain for accounting purposes.

Phase-in Plans

Special rules apply to so-called phase-in plans, as defined in SFAS 92, *Regulated Enterprises—Accounting for Phase-in Plans*. If a phase-in plan was ordered by regulators for a plant which had been substantially constructed before 1988, then all allowable costs which are deferred for regulatory purposes, subject to the phase-in plan, are also deferred for financial reporting purposes. However, imputed cost of capital permitted by regulators (in effect, interest on the deferred costs) cannot be capitalized for financial reporting. Specific criteria must be met in order to utilize phase-in accounting, and the method cannot be employed for plants not constructed until after 1987.

Abandonment

Accounting for abandonments is also stipulated for regulated enterprises. If an abandonment occurs or becomes probable, any costs which are probable of not being recovered should be written off as a loss. Furthermore, if the return on the investment which will be recoverable will not be equal to the normal rate of return, then an additional loss accrual must be recognized currently. This loss is measured by the difference between the projected future revenues, discounted at the enterprise's incremental borrowing rate, and the remaining costs to be recovered. The amount of loss to be recognized obviously depends on the enterprise's estimate of time to elapse until rate increases are effective, and the length of time over which the increases will remain in effect. These estimates may change over time, and the effect of revisions in the estimate will be reflected in earnings in the periods the new estimates are made.

The carrying value of the costs of an abandoned plant is increased during the period from the abandonment until recovery occurs through rate increases as promised by the regulatory authorities. If full return of investment is anticipated, the cost

of abandoned assets is accreted at the rate (the enterprise's overall cost of capital) permitted for rate setting purposes. If partial or no return on investment is expected, the asset value is accreted at the same rate which was used to compute the loss accrual, which is the enterprise's incremental borrowing rate. During the recovery period, the costs of the abandoned plant are amortized. If full return on investment is expected, this amortization should be computed on the same basis as is permitted for rate setting purposes. If partial or no return is expected, amortization should be such as to provide a constant rate of return on the unamortized balance of the investment in the costs of the abandoned plant.

Deferred Income Taxes

Deferred taxes must be provided consistent with SFAS 109. There are no exemptions or special provisions for income tax accounting for regulated enterprises. Assets or liabilities related to future rate increases or decreases are temporary differences within the meaning of SFAS 109.

EMERGING ISSUES TASK FORCE CONSENSUS SUMMARIES

■ EITF 92-7, *Accounting for Rate-Regulated Utilities for the Effects of Certain Alternative Revenue Programs*

A consensus was reached regarding the treatment of additional revenues of rate-regulated utility companies which are to be billed in the future under alternative revenue programs. The EITF abstract identifies two types of alternative revenue programs, defined as Type A and Type B. The revenues from alternative revenue programs should be recognized when the events permitting billing of the revenues have occurred and three specific criteria which are discussed in the abstract are met. The Task Force also notes that rate-regulated utilities recognizing revenues from an alternative revenue program which do not meet the conditions of this EITF must amend the plan or change the program to meet the conditions.

■ EITF 92-12, *Accounting for OPEB Costs by Rate-Regulated Enterprises*

If the regulator includes Other Post Employment Benefits, (OPEB), costs in rates on a pay-as-you-go basis, the regulatory asset relating to the cost under SFAS 106 should not be recognized. The Task Force also reached a consensus that the regulatory asset for a rate-regulated enterprise should recognize the difference between SFAS 106 costs and the OPEB costs if future revenue will at least offset the deferred cost and meet four specific criteria. The four specific criteria are discussed in detail in the EITF Abstracts.

■ EITF 93-4, *Accounting for Regulatory Assets*

The Task Force reached a consensus that a rate-regulated enterprise that fails to initially meet the asset recognition criteria can recognize a regulatory asset for Other Post Employment Benefits costs in a future period when applicable criteria are met. This consensus applies also to all regulatory assets recognized pursuant to SFAS 71 criteria. Additionally, the Task Force noted that the carrying amount of the regulatory asset to be recognized should be reduced by any impairment which may have occurred.

CHAPTER 21

SECURITIES AND COMMODITIES BROKER-DEALERS

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Address transactions in options, futures, and commodities.

OVERVIEW AND ISSUES

Despite the fact that brokers and dealers in securities and commodities represent major segments of the financial services industry, there is limited GAAP for the former and even less for the latter. A revised industry guide for brokers and dealers in securities was issued in 1995, and contains GAAP for enterprises in that industry. This guide also addresses, in a limited way, transactions in options, futures, and commodities. Reportedly, a separate industry accounting and auditing guide for commodities brokers and dealers (known as futures commission merchants, or FCMs) has been under preparation by the AICPA for a great many years, but is apparently not approaching completion.

SOURCES OF GAAP

- SFAS 83, *Designation of AICPA Guides and Statement of Position on Accounting by Brokers and Dealers in Securities, by Employee Benefit Plans, and by Banks as Preferable for Purposes of Applying APB Opinion 20—an amendment FASB Statement No. 32 and APB Opinion No. 30 and a rescission of FASB Interpretation No. 10*

RULES, CONCEPTS, AND ILLUSTRATIONS

Certain of the accounting and financial reporting issues affecting securities and commodities brokers and dealers arise from the regulated nature of these industries, with the former being subject to SEC reporting requirements and the latter receiving oversight from the Commodities Futures Trading Commission (CFTC). General purpose financial statements of securities and commodities brokers and dealers are prepared consistent with reporting requirements of the respective regulatory agencies, in most cases.

Accounting issues for entities in these industries center on timing of revenue and expense recognition (whether on a *trade date* basis or on a settlement date basis), and on the carrying values of inventories and investments (generally market value). Other items or transactions unique to or most commonly found in these industries include *fail to receive or deliver* amounts, repurchase and reverse repurchase balances receivable or payable, stock borrow and loan activities, customers' securities or funds held, margin account balances, and subordinated borrowings. This latter item is debt which, for purposes of certain regulatory measures, is accounted for as being equity capital.

CHAPTER 22

TITLE PLANTS

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Account for costs relating to the construction and operation of title plants.

OVERVIEW AND ISSUES

SFAS 61, *Accounting for Title Plant*, presents accounting and reporting standards for costs relating to the construction and operation of title plants. A title plant comprises a record of all transactions or conditions that affect titles to land located in a specified area. The length of time spanned by a title plant depends upon regulatory requirements and the time frame required to gather sufficient information to efficiently issue title insurance. Updating occurs frequently as documentation of the current status of a title is added to the title plant.

This pronouncement applies to enterprises such as title insurance companies, title abstract companies, and title agents that use a title plant in their operations. The standard provides that costs directly incurred to construct a title plant should be capitalized when the entity can use the title plant to do title searches and that such capitalized costs are not normally depreciated. The statement also requires that the costs of maintaining a title plant and of doing title searches be expensed as incurred.

SOURCES OF GAAP

- SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*.
- SFAS 61, *Accounting for Title Plant*.

TERMINOLOGY

Title plant. Consists of (a) indexed and catalogued information for a period concerning the ownership of, and encumbrances on, parcels of land in a particular geographic area; (b) information relating to persons having an interest in real estate; (c) maps and plats; (d) copies of prior title insurance contracts and reports; and (e) other documents and records. In summary, a title plant constitutes a historical record of all matters affecting title to parcels of land in a particular geographic area.

RULES, CONCEPTS, AND ILLUSTRATIONS

Acquisition Costs

The cost of constructing a title plant includes the cost of obtaining, organizing, and summarizing historical information pertaining to a particular tract of land. Costs incurred to assemble a title plant should be capitalized until the record is usable for conducting title searches. Costs incurred to construct a backplant (a title plant that antedates the time span of an existing title plant) must also be capitalized. SFAS 61, *Accounting for Title Plant*,

provides that costs directly incurred to construct a title plant should be capitalized when the entity can use the title plant to do title searches and that such capitalized costs are not normally depreciated.

The purchase of a title plant or an undivided interest in title plant (the right to its joint use) is recorded at cost as of the date acquired. If title plant is acquired separately, it is recorded at the fair value of consideration given. Backplant may also be purchased.

Capitalized title plant costs are not amortized or depreciated unless an impairment in the carrying amount of the title plant occurs. The following events or changes in circumstances, provided in para 5 of SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*, can indicate that the carrying amount may not be recoverable. An impairment may be indicated by the following circumstances:

1. Changing legal or statutory requirements
2. Economic factors, such as changing demand
3. Loss of competitive advantage
4. Failure to maintain an up-to-date title plant
5. Circumstances that indicate obsolescence, such as abandonment of title plant

The provisions of SFAS 121 apply to any such impairment.

Operating Costs

Costs of title plant maintenance and of conducting title searches must be expensed currently. A title plant is maintained through frequent, often daily, updating which involves adding reports on the current status of specific real estate titles and documentation of security or other ownership interests in such land. A title search entails a search for all information or documentation pertaining to a particular parcel of land. This information is found in the most recently issued title report.

Once a title plant is operational, costs may be incurred to convert the record from one storage and retrieval system to another or to modify the current storage and retrieval system. These costs may *not* be capitalized as title plant. However, they may be separately capitalized and amortized using a systematic and rational method.

Reporting Title Plant Sales

The sale of a title plant should be reported separately. The amount to be reported is determined by the circumstances surrounding the sale as follows:

<u>Terms of Sale</u>	<u>Amount Reported</u>
Sells title plant and waives all rights to future use	Amount received less adjusted cost of title plant
Sells undivided ownership interest (rights to joint use)	Amount received less pro rata portion of adjusted cost of title plant

Sells copies of title plant or the right to use it	Amount received
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Note that in the last instance the amount reported is simply the amount received. In this case no cost is allocated to the item sold unless the title plant's value drops below its adjusted cost as a result of the sale.

CHAPTER 23

VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS

LEARNING OBJECTIVES:

Upon completion of this chapter, you will be able to

- Discuss the auditing of and reporting on the financial statements of governmental voluntary health and welfare organizations (VHWO).
- Explain how to account for revenues and costs in a VHWO.
- State the requirements an organization must meet to be classified as a VHWO.
- Describe the typical funds used to account for VHWO transactions.

OVERVIEW AND ISSUES

The purpose of *Audits of Voluntary Health and Welfare Organizations* is to assist in the auditing of and reporting on the financial statements of *governmental* voluntary health and welfare organizations. The financial statements should be prepared in accordance with generally accepted accounting principles, unless they are inapplicable. Because the value of the services provided by most voluntary health and welfare organizations cannot be measured quantitatively, the primary purpose of the financial statements is to disclose the acquisition and use of the organization's resources. *Nongovernmental* organizations should use the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*.

The guide contains an example of an auditor's report, financial statements, and an investment pool.

SFAS 116, *Accounting for Contributions Received and Contributions Made*, establishes standards of accounting and reporting for contributions. It applies to all organizations that receive or make contributions. SFAS 117, *Financial Statements of Not-for-Profit Organizations*, addresses not-for-profit organizations, establishes standards for their general-purpose external statements and designates the statement of financial position, the statement of activities, the statement of cash flows and the accompanying notes as a complete set of financial statements. Inconsistent provisions in the SOPs or AICPA Guides are no longer acceptable specialized accounting and reporting.

Not-for-profits with annual expense of less than \$1 million and total assets of less than \$5 million can delay the effective date of SFAS 116 and SFAS 117 until fiscal years beginning after December 15, 1995.

SOURCES OF GAAP

- SFAS 93, *Recognition of Depreciation by Not-for-Profit Organizations*.
- SFAS 116, *Accounting for Contributions Received and Contributions Made*.
- SFAS 117, *Financial Statements of Not-for-Profit Organizations*.
- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations*

- of the Financial Accounting Standards Board to Not-for-Profit Organizations.*
- SOP 94-3, *Reporting of Related Entities by Not-For-Profit Organizations*

TERMINOLOGY

Not-for-profit organizations. Not operated for the financial benefit of specific individuals or groups of individuals.

Voluntary health and welfare organizations. Tax-exempt, not-for-profit organizations supported by the public to provide voluntary health, welfare, and community services to society and, in some cases, to specific individuals.

CONCEPTS, RULES, AND EXAMPLES

Financial Statements

Voluntary health and welfare organizations present the following financial statements:

1. Balance sheet
2. Statement of support, revenue and expenses and changes in fund balances
3. Statement of functional expenses in support of the total program and supporting services for the period

Current unrestricted funds and current restricted funds should be shown separately in the financial statements. Unrestricted funds that have been designated for specific purposes by the governing board should be identified.

A supplemental schedule of changes in the designation of portions of the current unrestricted fund for specific purposes may be included.

The financial statements should be prepared on an accrual basis. Cash basis or modified accrual basis may be used if there is no material difference from the accrual basis.

SFAS 117 requires the Statement of Financial Position to show total assets, total liabilities and net assets. Net assets must be categorized as to (1) unrestricted, (2) temporarily restricted or (3) permanently restricted. The same categories above are used in the Statement of Activities to show the changes in net assets. The Statement of Cash Flow should report the change in *cash and cash equivalents*.

Not-for-profit organizations must present in the financials all information required by GAAP (unless specifically exempted) and all information required by specialized principles. This information includes display and disclosure provisions of:

1. Financial instruments
2. Loss contingencies
3. Extraordinary, unusual and infrequent events
4. Accounting changes

Aggregation and order of presentation should, generally, be similar to those of a business enterprise.

In the Statement of Cash Flow, the Statement of Activities takes the place of the Income Statement in a business enterprise and change in net assets takes the place of net income. Restricted resources that are used for long-term purposes because of donor stipulation are classified as financing activities.

In the year of application, SFAS 117 does not need to be applied to interim periods. If reported with annual statements, however, interim periods should be reclassified for that year. In the initial year, disclosure is required, for each year presented, of (1) the nature of any restatements and (2) their effect on the change in net assets.

Restatement to reflect retroactive application is necessary if comparative financials are presented for earlier periods.

Voluntary health and welfare organizations must provide information about expenses by both their functional classification (major classes of program services and supporting activities) and their natural classification (salaries, rent, etc.) in a matrix format.

Fund Accounting

Voluntary health and welfare organizations usually use fund accounting because donors and/or external authorities may restrict or prohibit the use of some assets for operations. Unrestricted funds may be used as needed by the organization's governing board. Restricted funds are limited in use by the governing board due to external restrictions. Funds consist of a self-balancing group of accounts composed of assets, liabilities, and fund balances (net assets). The following fund groups are often used by voluntary health and welfare organizations:

1. Current unrestricted funds
2. Current restricted funds
3. Land, building, and equipment fund (plant fund)
4. Endowment funds
5. Custodian funds
6. Loan and annuity funds

Investments

Investments include investment of endowment and other restricted funds and investment of unrestricted funds. Purchased investments should be recorded at cost, including all costs associated with their purchase. Donated investments should be recorded at fair market value at the date of gift, unless they have declined in value. Investments may be carried at either cost or market value. The same basis should be used for all funds and should be disclosed in the financial statements. Investments of several funds are often pooled to increase investment flexibility. The market value method should be used for investment pools in order to fairly allocate the investment pool's income, gains, and losses among the funds.

Depreciation

Depreciation should be recognized. SFAS 93, *Recognition of Depreciation by Not-for-Profit Organizations*, also requires the disclosure of depreciation expense, balances of the major classes of depreciable assets, accumulated depreciation at the balance sheet date, and a description of the depreciation method used. Depreciation is not required for individual works of art or historical treasures with extremely long useful lives.

Public Support and Revenue

Public support is usually received from the following sources:

1. Direct mail campaigns
2. Door-to-door solicitation
3. Radio and television solicitation
4. Street sales and solicitation
5. Contributions from uncontrolled organizations (United Way, etc.)
6. Special events

Cash and pledges should be recorded when they are obtained. An allowance for uncollectible pledges should be used and should be disclosed in the financial statements. Cash and pledges that are designated for future use should be recorded as a deferred credit. Revenues are recorded for such items as membership dues and investment income.

Contributions

SFAS 116 specifies that unconditional promises to give and contributions received (made) are recognized at fair value in the period received (made). When conditions are substantially met, conditional promises to give are recognized.

Not-for-profits are required to differentiate increases in net assets from contributions between (1) permanently restricted, (2) temporarily restricted, and (3) unrestricted. In the period of expiration, recognition of the expiration of donor-imposed restrictions on contributions must be given. Service contributions should not be recognized *unless* (1) nonfinancial assets are created or enhanced or (2) qualified individuals provide specialized skills that would otherwise need to be purchased. Collections held for public exhibition, education or research in furtherance of public service and comprised of works of art, historical treasures, etc., are not required to be capitalized and recognized as revenue.

In the year of change, retroactive application or recognition of a cumulative effect may be used. Recognition of restriction expirations may be prospectively applied.

Expenditures

Expenditures should be identified by function and should include expenditures for program services, management and general costs, and fund-raising costs. Costs which are attributable to more than one function should be allocated on a reasonable basis.

Joint Costs of Informational Materials and Activities

In cases where joint costs include a fund-raising appeal, such costs should be reported as fund-raising expense unless it can be shown that a bona fide program or management and general function has been conducted in connection with the fund raising appeal (SOP 87-2). In that case, joint costs should be allocated between fund-raising and the legitimate program or management and general function.

GLOSSARY

Accounts receivable loan. A loan collateralized by the accounts receivable of the borrower.

Advance royalty. An amount paid to music publishers, record producers, songwriters, or other artists in advance of their earning royalties from record or music sales. Such an amount is based on contractual terms and is generally nonrefundable.

Affiliated enterprise. An enterprise that directly or indirectly controls, is controlled by, or is under common control with another enterprise; also, a party with which the enterprise may deal if one party has the ability to exercise significant influence over the other's operating and financial policies.

Barter. The exchange of unsold advertising time for products or services. The broadcaster benefits (providing the exchange does not interfere with its cash sales) by exchanging otherwise unsold time for such things as programs, fixed assets, merchandise, other media advertising privileges, travel and hotel arrangements, entertainment, and other services or products.

Broadcaster. An enterprise or an affiliated group of enterprises that transmits radio or television program material.

Cable television plant. The cable television plant required to render service to the subscriber includes the following equipment:

Cable--This consists of cable and amplifiers (which maintain the quality of the signal) covering the subscriber area, either on utility poles or underground. *Drops--These* consist of the hardware that provides access to the main cable, the short length of cable that brings the signal from the main cable to the subscriber's television set, and other associated hardware, which may include a trap to block particular channels.

Converters and descramblers--These devices are attached to the subscriber's television sets when more than 12 channels are provided or when special services are provided, such as "pay cable" or two-way communication.

Head-end--This includes the equipment used to receive signals of distant television or radio stations, whether directly from the transmitter or from a microwave relay system. It also includes the studio facilities required for operator-originated programming, if any.

Carrying amount. The face amount of the interest-bearing asset plus (or minus) the unamortized premium (or discount).

Closed-end fund. An investment company having a fixed number of shares outstanding, which it does not stand ready to redeem. Its shares are traded similarly to those of other public corporations.

Closed-up fund. An open-ended investment company that no longer offers its shares for

sale to the general public but still stands ready to redeem its outstanding shares.

Coding. Generating detailed instructions in a computer language to carry out the requirements described in the detail program design. The coding of a computer software product may begin prior to, concurrent with, or subsequent to the completion of the detail program design.

Commitment fees. Fees charged for entering into an agreement that obligates the enterprise to make or acquire a loan or to satisfy an obligation of the other party under a specified condition. For purposes of this Statement, the term commitment fees include fees for letters of credit and obligations to purchase a loan or group of loans and pass-through certificates.

Contractors. Include prime contractors and subcontractors.

Contracts. Refer to prime contracts and subcontracts.

Control. The ability to determine the direction of management and policy for purposes of presenting combined financial statements.

Cost-plus-fixed-fee contracts. Provide for contractors to receive a specified fixed fee and to be reimbursed for their allowable costs. Because title passes to the government and the contractor obtains an unconditional right to partial payment prior to delivery, delivery of the finished product is not necessarily evidence of performance.

Current (normal) servicing fee rate. A servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of mortgage loans.

Customer support. Services performed by an enterprise to assist customers in their use of software products. Those services include any installation assistance, training classes, telephone question and answer services, newsletters, on-site visits, and software or data modifications.

Daypart. An aggregation of programs broadcast during a particular time of day (for example, daytime, evening, late night) or programs of a similar type (for example, sports, news, children's shows). Broadcasters generally sell access to viewing audiences to advertisers on a daypart basis.

Dealer reserves. Finance company liabilities for dealers' shares of finance charges on retail contracts purchased from dealers.

Detail program design. The detail design of a computer software product that takes product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.

Direct consumer loan. A two-party transaction in which the finance company lends funds directly to the borrower; such a loan may or may not be collateralized.

Direct selling costs. Direct selling costs include commissions, the portion of a salesperson's compensation other than commissions for obtaining new subscribers, local advertising targeted for acquisition of new subscribers, and costs of processing documents related to new subscribers acquired. Direct selling costs do not include supervisory and administrative expenses or indirect expenses, such as rent and costs of facilities.

Discount factoring. See **factoring**.

Discount loan. A loan that is written with the interest or finance charges included in the face amount of the note. Discount loans are also called precompute or add-on loans.

Discount. Amount deducted from the face value in advance as a charge for the loan or a deduction for interest at the time of the loan or any charge for credit that is precomputed and included in the face of the instrument.

Disposal Credits. Deductions from the termination claim receivable for approved retention or sale of inventory previously included in the claim.

Distributor (film distributor). Owner of the rights to distribute films, which are sold (licensed) to movie theaters, individual television stations, groups of stations, networks, or others. This definition excludes syndicators or other independent sales organizations that act only as sales agents for producers or owners of films under agreements that do not call for the sharing of profits.

Effective interest rate. The implicit rate of interest based on the amount advanced and the amount and timing of the specified repayments over the period of the contract.

Equalization. An accounting method used to prevent a dilution of the continuing shareholders' per share equity in undistributed net investment income caused by the continuous sales and redemptions of capital shares.

Ex-dividend or ex-distribution. Synonym for shares being traded without dividend or without capital gains distribution.

Exploitation costs. Costs incurred during the final production phase and during the release periods of films in both primary and secondary markets. Examples of such costs are film prints, advertising, rents, salaries, and other distribution expenses.

Factor. A company that engages primarily in factoring.

Factoring. Purchase, usually without recourse, of individual accounts receivable arising in the client's ordinary course of business. Under a factoring agreement, the finance company also provides credit checking, collection and recordkeeping services.

Federal Home Loan Mortgage Corporation (FHLMC). Often referred to as “Freddie Mac,” a private corporation authorized by Congress to assist in the development and maintenance of a secondary market in conventional residential mortgages. FHLMC purchases mortgage loans and sells mortgages principally through mortgage participation certificates (PCs) representing an undivided interest in a group of conventional mortgages. FHLMC guarantees the timely payment of interest and the collection of principal on the PCs.

Federal National Mortgage Association (FNMA). Often referred to as “Fannie Mae,” an investor-owned corporation established by Congress to support the secondary mortgage loan market by purchasing mortgage loans when other investor funds are limited and selling mortgage loans when other investor funds are available.

Floor plan checking. Physical inspection of dealer’s inventories that are collateral for advances to the dealer to be repaid from the proceeds from sale of specific items. Sometimes referred to as floor plan auditing.

Floor planning. Financing of dealers’ inventories, particularly automobiles and other consumer goods, sometimes referred to as wholesaling. The dealers are obliged to repay the supplier or manufacturer from proceeds of sale of specific items, or after an elapsed period even though inventory is not sold.

Franchise. A contractual arrangement whereby a franchisor grants business rights and provides services to a franchisee who in return agrees to pay an initial franchise fee to operate a business and pay continuing fees based on the operations of the business.

Franchisee. The party who operates the franchised business.

Franchisor. The party who grants business rights under the franchise.

Gap commitment. A commitment to provide interim financing while the borrower is in the process of satisfying provisions of a permanent loan agreement, such as obtaining a designated occupancy level on an apartment project. The interim loan ordinarily finances the difference between the floor loan (the portion of a mortgage loan commitment that is less than the full amount of the commitment) and the maximum permanent loan.

General reserve. Used in the context of the special meaning this term has in regulatory pronouncements and in the U.S. Internal Revenue Code.

Government National Mortgage Association (GNMA). Often referred to as “Ginnie Mae,” a U.S. governmental agency that guarantees certain types of securities (mortgage-backed securities) and provides funds for and administers certain types of low-income housing assistance programs.

Home viewing market. All means by which films are sold or otherwise made available to

residential viewers for a fee. Examples are video cassettes and disks and all forms of pay television, including cable and over-the-air transmission.

Incremental direct costs. Costs to originate a loan that (a) result directly from and are essential to the lending transaction and (b) would not have been incurred by the lender had that lending transaction not occurred.

Independent producer. Motion picture companies frequently advance funds or guarantee loans for the production of films by independent producers. Certain legal rights of ownership, including the copyright, may be retained by the independent producer. The motion picture company frequently has a participation in the net revenues from the film and generally has additional attributes of ownership, such as the right to exploit the film and the risk of loss. The financing arrangement usually provides that the production loan by the motion picture company (or the guaranteed loan) is repayable only from the revenues from the particular film. The independent producer does not have general liability with respect to such a loan. Consequently, the motion picture company bears substantially all the risks of ownership.

Initial franchise fee. Consideration for establishing the franchise relationship and providing some initial services.

Insurance transaction. Transaction in which (1) the purchaser of an insurance contract makes an initial payment or deposit to the insurance company in advance of the possible occurrence or contingency and (2) the insurance company does not know if, how much, or when amounts will be payable to the insured when the insurance contract is consummated.

Interest method. A method of computing income under which interest income on a fixed-rate obligation is accrued over the life of the loan based on a constant rate (percent) of interest applied to the outstanding loan balance. As a result, the amount of income recognized at a given time is directly proportional to the outstanding loan balance. Also called the actuarial method.

Interest-bearing loan. A loan that is written at the principal amount advanced to the borrower and bearing interest computed monthly on the unpaid balance.

Internal reserve method. A method for making payments to investors for collections of principal and interest on mortgage loans by issuers of GNMA securities. An issuer electing the internal reserve method is required to deposit in a custodial account an amount equal to one month's interest on the mortgage loans that collateralize the GNMA security issued.

Inventory loan. A loan collateralized by inventory of the borrower.

License agreement for program material. A typical license agreement for program material (for example, features, specials, series, or cartoons) covers several programs (a package) and grants a television station, group of stations, network, pay television, or cable television system (licensee) the right to broadcast either a specified number or an unlimited

number of showings over a maximum period of time (license period) for a specified fee. Ordinarily, the fee is paid in installments over a period generally shorter than the license period. The agreement usually contains a separate license for each program in the package. The license expires at the earlier of the last allowed telecast or the end of the license period. The licensee pays the required fee whether or not the rights are exercised. If the licensee does not exercise the contractual rights, the rights revert to the licensor with no refund to the licensee. The license period is not intended to provide continued use of the program material throughout that period but rather to define a reasonable period of time within which the licensee can exercise the limited rights to use the program material.

License agreement for television program material. A typical license agreement for television program material covers several films (a package) and grants a broadcaster (licensee) the right to telecast either a specified number or an unlimited number of showings over a maximum period of time (license period) for a specified fee. Ordinarily, the fee is paid in installments over a period generally shorter than the license period. The agreement usually contains a separate license for each film in the package. The license expires at the earlier of the last allowed telecast or the end of the license period. The licensee pays the required fee whether or not the rights are exercised. If the licensee does not exercise the contractual rights, the rights revert to the licensor with no refund to the licensee. The license period generally is not intended to provide continued use of the film throughout that period but rather to define a reasonable period of time within which the licensee can exercise the limited rights to use the film.

License agreements. Contractual arrangements entered into by an owner (licensor) of a record master or music copyright with a licensee granting the licensee the right to sell or distribute records or music for a fixed fee paid to the licensor or for a fee based on sales of records or music. License agreements are modifications of the compulsory provisions of the copyright law.

Long-term interest-bearing assets. For purposes of this section, these are interest-bearing assets with a remaining term to maturity of more than one year.

Maintenance. Activities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions.

Market. The first market in which a film is exploited is called the primary market because that is the market for which a film principally is produced. All other exploitation is in the secondary market. Generally, the markets are mutually exclusive; that is, a film cannot be exploited in more than one market at a time because of the contract terms or sound marketing techniques. There is only one first-run telecast of a particular film in a given market, and film rights are marketed in a manner to avoid conflict in a given market. For example, conflict may exist in a market between (a) theaters and television stations, (b) premium cable or broadcast subscription television and network television, (c) network television and local stations, and (d) two or more local stations within the market area. To avoid conflict between theaters and television, a producer may impose restrictions on

distribution that would prohibit the licensing of the film for television while the film is being shown in movie theaters. The market in which a film is exhibited is a prime determinant of the value of the film. A film's previous exposure in a market will generally have an effect on the price the exhibitor is willing to pay for exhibition rights. In addition, the size and demographics of a particular market and the audience's acceptance of the film affect the price that a telecaster can charge for advertising time.

Mineral interests in properties. Generally referred to as *properties*, fee ownership or a lease, concession, or other interest that provides the right to extract oil or gas.

Minimum guarantee. An amount paid in advance by a licensee to a licensor for the right to sell or distribute records or music.

Mortgage banking enterprise. An enterprise that is engaged primarily in originating, marketing, and servicing real estate mortgage loans for other than its own account. Mortgage banking enterprises, as local representatives of institutional lenders, act as correspondents between lenders and borrowers.

Mortgage-backed securities. Securities issued by a governmental agency or corporation (for example, GNMA or FHLMC) or by private issuers (for example, FNMA, banks, and mortgage banking enterprises). Mortgage-backed securities generally are referred to as *mortgage participation certificates* or *pass-through certificates* (PC5). A PC represents an undivided interest in a pool of specific mortgage loans. Periodic payments on GNMA PCs are backed by the U.S. government. Periodic payments on FHLMC and FNMA PCs are guaranteed by those corporations, but are not backed by the U.S. government.

Motion picture film. All types of films and video cassettes and disks, including features, television specials, series, and cartoons that are (a) exhibited in theaters; (b) licensed for exhibition by individual television stations, groups of stations, networks, cable television systems, or other means; or (c) licensed for the home viewing market.

Net realizable value. Net realizable value is the estimated selling price (rental value) in the ordinary course of business less estimated costs to complete and exploit in a manner consistent with realization of that income.

Net-spread method. Under this method, the acquisition of a savings and loan association is viewed as the acquisition of a leveraged whole rather than the acquisition of the separate assets and liabilities of the association.

Network affiliation agreement. A broadcaster may be affiliated with a network under a network affiliation agreement. Under the agreement the station receives compensation for the network programming that it carries based on a formula designed to compensate the station for advertising sold on a network basis and included in network programming. Program costs, a major expense of television stations, are generally lower for a network affiliate than for an independent station because an affiliate does not incur program costs for network programs.

No-cost settlements. Settlements in which the contractor waives the right to make a claim. No sale should be recorded and applicable costs should retain their usual classification.

Nonrefundable fee. Any charge made in connection with a loan that does not have to be refunded to the borrower when the loan is prepaid.

Not-for-profit organizations. Not operated for the financial benefit of specific individuals or groups of individuals.

Open-end investment company. A mutual fund that sells its shares to the public on an ongoing basis and is always willing to buy back its shares from investors who tender them for redemption.

Origination fees. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. This term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction and also includes syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

Overadvance (in factoring). An amount advanced to a client in excess of the amount of uncollected receivables purchased by the factor.

Participation. Frequently, persons involved in the production of a motion picture film are compensated, in part or in full, with a participation in the income from the film. Determination of the amount of compensation payable to the participant is usually based on percentages of revenues or profits from the film from some or all sources. Television residuals are comparable to participations and are generally based on the number of times the film is exhibited on television or as a percentage of revenues from such exhibition.

Permanent investor. An enterprise that invests in mortgage loans for its own account, for example, an insurance enterprise, commercial or mutual savings bank, savings and loan association, pension plan, real estate investment trust, or FNMA.

Points. Amounts, generally expressed as a percent of the loan, charged for granting loans, that primarily are adjustments of yield but also may be intended to cover costs such as underwriting, loan application processing, and reviewing title to collateral.

Pretax accounting income. Represents income or loss for a period, exclusive or related income tax expense, determined in conformity with generally accepted accounting principles.

Producer. An individual or motion picture enterprise that produces films for exhibition in movie theaters, on television, or elsewhere.

Product design. A logical representation of all product functions in sufficient detail to serve as product specifications.

Product enhancement. Improvements to an existing product that are intended to extend the life or improve significantly the marketability of the original product. Enhancements normally require a product design and may require a redesign of all or part of the existing product.

Product masters. A completed version, ready for copying, of the computer software product, the documentation, and the training materials that are to be sold, leased, or otherwise marketed.

Production costs. The cost of a story and scenario to be used for a film and other costs to produce a film, for example, salaries of cast, directors, producers, extras, and miscellaneous staff; cost of set construction and operations, wardrobe, and all accessories; cost of sound synchronization; production overhead, including depreciation and amortization of studio equipment and leasehold improvements used in production; and rental of facilities on location. Production costs ordinarily are accumulated by individual films in four chronological steps: (a) acquisition of the story rights; (b) preproduction, which includes script development, costume design, and set design and construction; (c) principal photography, which includes shooting the film; and (d) postproduction, which includes sound synchronization and editing, culminating in a completed master negative.

Proved properties. Properties with proved reserves.

Record master. The master tape resulting from the performance of the artist. It is used to produce molds for commercial record production and other tapes for use in making cartridges, cassettes, and reel tapes.

Research and development expenditures. They include (1) internally developed software used for a particular current research and development project as well as (2) purchased or leased software that is used in research and development activities of the entity that do not have any alternative future uses.

Reserve for bad debts. Term is used in the context of the special meaning this term has in regulatory pronouncements and in the U.S. Internal Revenue Code.

Restricted Current Funds. The funds which may be used for operations, but can only be used for the specific purpose designated by a donor or other external agency.

Retail land sales. Large amounts of residential lot sales of subdivisions of large tracts of land.

Royalties. Amounts paid to record producers, songwriters, or other artists for their participation in making records and to music publishers for their copyright interest in music. Amounts for artists are determined by the terms of personal service contracts negotiated between the artists and record companies and usually are determined based upon a percentage of sales activity and license fee income, adjusted for estimated sales

returns. Royalties for publishing are based on the copyright or other applicable laws, but the requirements of the law may be modified by licenses issued by the publishers.

Separate-valuation method. Under this method, each of the identifiable assets and liabilities (assumed) of the acquired savings and loan association is accounted for in the consolidated financial statements at an amount based on fair value at the date of acquisition, either individually or by types of assets and types of liabilities.

Service contracts. Contracts in which the contractor acts only as an agent.

Servicing. Mortgage loan servicing includes collecting monthly mortgagor payments, forwarding payments and related accounting reports to investors, collecting escrow deposits for the payment of mortgagor property taxes and insurance, and paying taxes and insurance from escrow funds when due.

Standby commitment. A commitment to lend money with the understanding that the loan probably will not be made unless permanent financing cannot be obtained from another source. Standby commitments ordinarily are used to enable the borrower to obtain construction financing on the assumption that permanent financing will be available on more favorable terms when construction is completed. Standby commitments normally provide for an interest rate substantially above the market rate in effect when the commitment is issued.

Subcontractor's claims. Claims made in conjunction with a terminated contract are costs for the terminated contract that do not result in the transfer of billable materials or services to the contractor before termination.

Subscriber-related costs. These are costs incurred to obtain and retain subscribers to the cable television system and include costs of billing and collection, bad debts, and mailings; repairs and maintenance of taps and connections; franchise fees related to revenues or number of subscribers; general and administrative system costs, such as salary of the system manager and office rent; programming costs for additional channels used in the marketing effort or costs related to revenues from, or number of subscribers to, per channel or per program service; and direct selling costs.

Supply contracts. Contract in which the contractor's services extend beyond that of an agent. Contracts include services such as the use of the contractor's own facilities and responsibility to creditors for material and services, and to employees for salaries.

Taxable income. Represents pretax accounting income (a) adjusted for reversal of provisions of estimated losses on loans and property acquired in settlement of loans, gains or losses on the sales of such property, and adjusted for permanent differences and (b) after giving effect to the bad debt deduction allowable by the U.S. Internal Revenue Code assuming the applicable tax return were to be prepared based on such adjusted pretax accounting income.

Testing. Performing the steps necessary to determine whether the coded computer software product meets function, feature, and technical performance requirements set forth in the product design.

Title plant. Consists of (a) indexed and catalogued information for a period concerning the ownership of, and encumbrances on, parcels of land in a particular geographic area; (b) information relating to persons having an interest in real estate; (c) maps and plats; (d) copies of prior title insurance contracts and reports; and (e) other documents and records. In summary, a title plant constitutes a historical record of all matters affecting title to parcels of land in a particular geographic area.

Unrestricted Current Funds. The funds of educational organizations that may be used for any operational purpose and have not been restricted or designated for any other purpose.

Voluntary health and welfare organizations (VHWOs). Tax-exempt, not-for-profit organizations supported by the public to provide voluntary health, welfare, and community services to society and, in some cases, to specific individuals.

Working model. An operative version of the computer software product that is completed in the same software language as the product to be ultimately marketed, performs all the major functions planned for the product, and is ready for initial customer testing (usually identified as *beta testing*).