

Q&A Section 1000

FINANCIAL STATEMENT PRESENTATION

TABLE OF CONTENTS

Section

1100	Statement of Financial Position
	[.01] Reserved
	[.02] Reserved
	.03 Unclassified Balance Sheet for Venture With Limited Life
	[.04] Reserved
	[.05] Reserved
	[.06] Reserved
	.07 Comparative Statement Disclosures
	.08 Classification of Outstanding Checks
	[.09] Reserved
	[.10] Reserved
	[.11] Reserved
	[.12] Reserved
	[.13] Reserved
	.14 Classification of Convertible Debt
	.15 Liquidity Restrictions
1200	Income Statement
	.01 Disclosure of Revenues of an Agent
	[.02] Reserved
	[.03] Reserved
	.04 Statement Title When There Is a Net Loss
	.05 Presentation of Reimbursed Payroll Expense
	.06 Note to Q&A Section 1200.07 to 1200.16—Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk
	.07 Finite Insurance
	.08 Insurance Risk Limiting Features
	.09 Transfer of Insurance Risk
	.10 Accounting Guidance for Transfer of Insurance Risk
	.11 Differences Between Retroactive and Prospective Insurance
	.12 Accounting for Prospective Insurance
	.13 Accounting for Retroactive Insurance
	.14 Accounting for Multiple-Year Retrospectively Rated Insurance
	.15 Deposit Accounting
	.16 Identifying Accounting Model for Insurance Transactions

Section

1300	Statement of Cash Flows
	[.01] Reserved
	[.02] Reserved
	.03 Comparative Statements of Cash Flows
	[.04] Reserved
	.05 Statement of Cash Flows for Annual Report With Balance Sheet Only
	[.06] Reserved
	[.07] Reserved
	[.08] Reserved
	[.09] Reserved
	.10 Special Purpose Frameworks
	.11 The Effect of an Error Correction on the Statement of Cash Flows When Single Period Statements Are Presented
	[.12] Reserved
	[.13] Reserved
	[.14] Reserved
	.15 Presentation of Cash Overdraft on Statement of Cash Flows
	.16 Purchase of Inventory Through Direct Financing
	.17 Omission of Reconciliation of Net Income to Cash Flow From Operations
	[.18] Reserved
	.19 Classification of Payments on Equipment Finance Note
	.20 Direct vs. Indirect Method for Statement of Cash Flows
	.21 Presentation of Financing Transaction on Statement of Cash Flows
	.22 Negative Amortization of Long-Term Debt in Cash Flows Statement
1400	Consolidated Financial Statements
	[.01] Reserved
	.02 Consolidation of Corporation and Proprietorship
	[.03] Reserved
	[.04] Reserved
	[.05] Reserved
	.06 Combined and Separate Financial Statements
	.07 Reporting on Company Where Option to Acquire Control Exists
	[.08] Reserved
	[.09] Reserved
	[.10] Reserved
	[.11] Reserved
	[.12] Reserved
	[.13] Reserved
	[.14] Reserved
	[.15] Reserved

Section

1400	Consolidated Financial Statements—continued
	[.16] Reserved
	[.17] Reserved
	[.18] Reserved
	[.19] Reserved
	[.20] Reserved
	[.21] Reserved
	.22 Intervening Intercompany Transactions Between Subsidiary's and Parent's Year-End
	.23 Conforming Subsidiary's Inventory Pricing Method to Its Parent Company's Method
	[.24] Reserved
	.25 Issuance of Parent Company Only Financial Statements
	.26 Consolidated Versus Combined Financial Statements
	.27 Subsidiary Financial Statements
	[.28] Reserved
	.29 Consolidated Versus Combined Financial Statements Under FASB ASC 810, <i>Consolidation</i>
	.30 Stand-Alone Financial Statements of a Variable Interest Entity
	.31 GAAP Departure for FASB ASC 810
	.32 Parent-Only Financial Statements and Relationship to GAAP
	[.33] Reserved
1500	Financial Statements Prepared in Accordance With a Special Purpose Framework
	[.01] Reserved
	[.02] Reserved
	[.03] Reserved
	.04 Terminology for Special Purpose Financial Statements
	[.05] Reserved
	[.06] Reserved
	.07 Disclosure Concerning Subsequent Events in Special Purpose Financial Statements
1600	Personal Financial Statements
	[.01] Reserved
	[.02] Reserved
	.03 Social Security Benefits—Personal Financial Statements
	.04 Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements
1700	Prospective Financial Statements
	[.01] Reserved
1800	Notes to Financial Statements
	[.01] Reserved
	[.02] Reserved
	.03 Disclosure of Change in Fiscal Year
	[.04] Reserved

Section

- 1800 Notes to Financial Statements—continued
- .05 Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments
 - .06 Applicability of Fair Value Disclosure Requirements in FASB ASC 820 to Financial Statements Prepared in Accordance With a Special Purpose Framework
- 1900 Interim Financial Information
- .01 Condensed Interim Financial Reporting by Nonissuers
-

Q&A Section 1100***Statement of Financial Position***

[.01] Reserved

[.02] Reserved

.03 Unclassified Balance Sheet for Venture With Limited Life

Inquiry—A corporation has recently been organized with the sole purpose of constructing a shopping center which will take several years to complete, after which the company will be liquidated. The company uses the completed contract method to recognize income, and will have only one operating cycle. Would an unclassified balance sheet be appropriate?

Reply—An unclassified balance sheet would be more appropriate than a classified one in this situation. The sole purpose of the corporation is to construct the shopping center, and the appropriate time frame for reporting purposes, by definition, becomes the time required to complete the project, rather than an arbitrary one-year period.

[.04] Reserved

[.05] Reserved

[.06] Reserved

.07 Comparative Statement Disclosures

Inquiry—When financial statements of the prior period are presented on a comparative basis with financial statements of the current period, should the notes to the comparative financial statements disclose details for the prior year?

Reply—Generally, in practice notes to comparative financial statements are also comparative if they present details of items on the financial statements or are otherwise pertinent. For example, details of notes payable outstanding at the end of each period are normally disclosed, but the future maturities disclosure need only be disclosed for the current year.

[Amended, June 1995.]

.08 Classification of Outstanding Checks

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

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

[.09] Reserved

[.10] Reserved

[.11] Reserved

[.12] Reserved

[.13] Reserved**.14 Classification of Convertible Debt**

Inquiry—A company has debt that is convertible into common stock of the company at the option of the company. The debt by its terms is considered long-term debt in the classified balance sheet. The company intends to call the debt and issue the common stock within one year of the balance sheet date. Should this debt be classified as a current liability?

Reply—No. The expected call of the debt securities will not consume current assets or increase current liabilities, and accordingly should continue to be classified as a long-term obligation.

The general principle underlying the classification of debt in a debtor's principal balance sheet should be based on facts existing at the date of the balance sheet rather than on expectations. According to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, the term *current liabilities* "is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities."

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.15 Liquidity Restrictions

Inquiry—Entities may invest in assets such as money market funds or other short term investment vehicles from which they generally may withdraw funds at any time without prior notice or penalty, but for which the fund (or its trustee) may restrict the ability of an entity to withdraw its balance in the fund or other short term investment vehicle. In some circumstances, with little or no notice, the fund (or its trustee) may impose such withdrawal restrictions. For example, the fund (or its trustee), in accordance with the terms of the fund, may, with little or no notice, stipulate that up to 20 percent of the fund balance can be withdrawn immediately, an additional 30 percent can be withdrawn in 6 months, and the remaining balance can be withdrawn in 2 years.

What are the potential accounting and auditing implications of such an event for a nongovernmental entity (the event being restrictions on the ability of an entity to withdraw its balance in the money market fund or other short term investment vehicle)?

Reply—The following are examples of potential accounting and auditing issues that may be relevant if such an event exists. Each situation is different and should be evaluated based on its specific facts and circumstances:

Balance Sheet Classification. Such withdrawal restrictions should be considered in determining whether such assets meet the definition of *cash equivalents*. (This technical question and answer does not address whether such assets met the definition of *cash equivalents* prior to the imposition of such withdrawal restrictions.)

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary provides a definition of *cash equivalents* for the purposes of applying FASB ASC 230, *Statement of Cash Flows*.

Such withdrawal restrictions should be considered in determining whether such assets meet the definition of *current assets*.

FASB ASC glossary defines *current assets* for balance sheet classification purposes.

For entities that do not prepare a classified balance sheet, such withdrawal restrictions should be considered in determining the sequencing of assets on the balance sheet or disclosures in the notes to financial statements providing relevant information about the liquidity or maturity of assets.

Disclosures. The entity may be required to provide financial statement disclosures about such events. For example, such events may create or lead to risks and uncertainties pertaining to certain significant estimates, such as measurement, liquidity, and violation of debt covenants, and vulnerability from concentrations of investments in volatile markets. Entities should consider whether they should make disclosures in their financial statements (beyond those required or generally made in financial statements) about the risks and uncertainties resulting from such events and existing as of the date of the financial statements. In addition, auditors should consider whether such disclosures include forward-looking statements that are not required by generally accepted accounting principles and therefore may not be audited.

FASB ASC 275, *Risks and Uncertainties*, provides guidance pertaining to disclosures about risks and uncertainties.

Debt Covenants. Such events may result in balance sheet classifications (balance sheet classifications are previously discussed) and other events that may trigger violations of debt covenants. If a covenant violation occurs, issuers of debt should consider whether that covenant violation triggers classification of the debt liability as current (or otherwise affects reported information about liquidity) or cross covenant violations in other arrangements.

FASB ASC glossary defines *current assets* and *current liabilities* for balance sheet classification purposes. FASB ASC 470-10-45-11 clarifies how the debtor should present obligations that are callable by the creditor in a balance sheet in which liabilities are classified as current or noncurrent.

Paragraphs 12A–12B of FASB ASC 470-10-45 provide guidance for the classification of short-term obligations that are expected to be refinanced on a long-term basis.

FASB ASC 470-10-45 and FASB ASC 470-10-55 address the classification of obligations at the balance sheet date that are not callable at the balance sheet date, but that become callable by violation of a debt agreement provision after the balance sheet date but before the financial statements are issued.

FASB ASC 470-10-45-2 and FASB ASC 470-10-50-3 provide guidance pertaining to balance sheet classification in circumstances in which debt agreements include subjective acceleration clauses.

Events Occurring Subsequent to the Balance Sheet Date. Events occurring subsequent to the balance sheet date, but prior to the issuance of the financial statements, such as significant changes in fair value or changes in liquidity leading to violation of debt covenants, may need to be reflected in the financial statements (either through adjustment to or disclosure in the financial statements).

AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to subsequent events and subsequently discovered facts in an audit of financial statements.

Going Concern. Certain events (some interrelated) could call into question the entity's ability to continue as a going concern. For example:

- The inability to withdraw funds can pose significant challenges to the entity's liquidity.
- As discussed earlier, balance sheet reclassifications or other events may trigger violations of debt covenants.

AU-C section 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), addresses the auditor's responsibilities in an audit of financial statements with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.

AU-C section 260, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), addresses the auditor's responsibility to communicate with those charged with governance.

Paragraph .06 of AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), requires that if the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor should include an emphasis-of-matter paragraph in the auditor's report, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. For example, the auditor may wish to refer, in the auditor's report, to financial statement disclosures about restrictions on liquidity pertaining to such events.

[Issue Date: October 2008; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos.

122–126.]

Q&A Section 1200***Income Statement*****.01 Disclosure of Revenues of an Agent**

Inquiry—Company A is in the business of arranging sales of used cars for which service it receives a commission based on an established fee schedule. Company A receives title to the cars sold but simultaneously transfers title to the car buyer. Company A warrants main engine components for thirty days after date of sale.

The following presentations of revenue in the income statement are being considered:

Commission Earned	<u>\$20,000</u>
or	
Sales	\$300,000
Cost of Sales	<u>(280,000)</u>
Gross Profit (or Net Commissions)	\$20,000

What is the proper presentation of revenue?

Reply—Since Company A is operating as a broker, Company A should report Commissions Earned rather than Sales. However, Company A could disclose above the Commissions Earned figure, without showing a deduction, the amount of sale, as follows:

Sales Arranged	<u>\$300,000</u>
Commissions Earned	<u>\$20,000</u>
Expenses, etc.	XXX

Company A should also make proper provision for the cost of warranties.

[.02] Reserved**[.03] Reserved****.04 Statement Title When There Is a Net Loss**

Inquiry—What title is suggested for the "Statement of Income" when a "net loss" exists in one or more years?

Reply—Companies included in the annual survey entitled *Accounting Trends & Techniques* ("Trends") file with the Securities and Exchange Commission. Accordingly, their annual reports include a three year statement of income. If a current year net loss is shown in the income statement, the "Trends" companies usually describe the statement of income as the "Statement of Operations." They occasionally use the title "Statement of Income (Loss)" and very rarely use the title "Statement of Loss."

Some companies always use "Statement of Operations" since the heading will be the same whether there is a "net loss" or "net income."

.05 Presentation of Reimbursed Payroll Expense

Inquiry—One company of a controlled group, in addition to its own operations, acts as a "paymaster" for the entire group. This company records the entire payroll of all members in the group on its general ledger to facilitate reconciliation with state and federal payroll tax returns. Each member of the group reimburses the "paymaster" for its share of payroll and payroll taxes and records management fee expense while the paymaster records it as management fee income.

Should the reimbursement be classified as other income in the separate income statement of the "paymaster" company?

Reply—No. The reimbursement should be allocated as a reduction of payroll and payroll tax expense because this approach would more accurately present the "paymaster" company's expenses for its own operations.

.06 Note to Q&A Section 1200.07 to 1200.16—Accounting by Non-insurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk

Insurance enables a company (the insured) to transfer insurance risk to an insurer for a specified premium. Insurance may be purchased for a number of economic reasons generally with the underlying goal of transferring insurance risk, including property damage, injury to others, and business interruption.

The following series of questions and answers (Sections 1200.07–.16) focus on certain aspects of finite insurance products that are utilized by noninsurance enterprises. Due to the diverse nature of contracts in the marketplace, the guidance in these questions and answers is designed to assist practitioners in identifying the relevant literature to consider in addressing their specific facts and circumstances. The TPAs contain many excerpts of applicable guidance, but readers should be familiar with all the guidance contained in that literature not only the specific paragraphs listed.

GAAP guidance for an insurance enterprise's purchase of reinsurance is more extensive than guidance on accounting by noninsurance enterprises for insurance contracts. The accounting guidance for reinsurance addresses transactions between an insurer (the contract holder) and a reinsurer (the issuer of the contract). Q&A sections 1200.07–.16 address property and casualty insurance contracts between a policyholder and an insurance enterprise, which is similar to the relationship between an insurer and a reinsurer.

.07 Finite Insurance

Inquiry—What are "finite" insurance transactions?

Reply—Finite insurance contracts are contracts that transfer a clearly defined and restricted amount of insurance risk from the policyholder to the insurance company, and the policyholder retains a substantial portion of the related risks under most scenarios. Nevertheless, under certain finite contracts there may be a reasonable possibility that the insurance company will incur a loss on the contract.

.08 Insurance Risk Limiting Features

Inquiry—What types of insurance risk limiting features do finite insurance contracts normally contain?

Reply—Contractual features that serve to limit insurance risk transfer are found in both traditional and finite insurance contracts; however, the degree to which these features limit risk is relatively higher in finite insurance. All

contractual provisions that limit risk transfer need to be considered when reviewing insurance contracts. Common features that may limit the transfer of insurance risk include:

- *Sliding scale fees and profit sharing formulae.* These features adjust cash flows between the policyholder and insurance company based on loss experience (for example, increasing payments from the insured enterprise as losses increase and decreasing payments as losses decrease, subject to maximum and minimum limits).
- *Experience refunds.* These arrangements allow the policyholder to share in the favorable experience of the underlying contracts by reference to an "experience account" that typically tracks premiums paid, less fees, less losses incurred, plus interest. Experience provisions also can require the policyholder to share in unfavorable experience by requiring additional payments to the insurer in the event that the experience account is negative.
- *Caps.* Caps are used to limit the insurer's aggregate exposure by imposing a dollar limit, or a limit expressed as a percentage of premiums paid, on the amount of claims to be paid by the insurer. For example, the insurer will not be responsible for losses beyond 150 percent of the premiums paid. While commercial insurance policies usually have limits on the amount of coverage provided, there may be significant risk mitigation for the insurer if the premium paid is a substantial percentage of the maximum coverage provided.
- *Loss Corridors.* This feature, which may exist in various forms, serves to eliminate or limit the risk of loss for a specified percentage or dollar amount of claims within the contract coverage. For example, in a contract providing coverage for a policyholder's first \$3,000,000 of losses, the insurer will pay the first million and last million of losses but will exclude the corridor from \$1,000,000 to \$2,000,000.
- *Dual-triggers.* This feature requires the occurrence of both an insurable event and changes in a separate pre-identified variable to trigger payment of a benefit/claim. An example is a policy entered into by a trucking company that insures costs associated with rerouting trucks over a certain time period if snowfall exceeds a specified level during that time period.
- *Retrospectively-Rated Premiums.* Such premiums are determined after the inception of the policy based on the loss experience under the policy.
- *Reinstatement Premiums.* To the extent the coverage provided by a contract is absorbed by losses incurred, the contract provides for the policyholder to reinstate coverage for the balance of the contract period for a stated additional premium. To the extent reinstatement is required rather than optional, the additional premium may mitigate risk to the insurer.
- *Termination Provisions.* These provisions can be structured to reduce the risk of the insurer, for example, by allowing for termination by the insurer at a discounted amount under certain circumstances.

- *Payment Schedules.* Features that delay timely reimbursement of losses by the insurer prevent the transfer of insurance risk.

There may be other features and provisions, in addition to the list of common insurance risk transfer limiting features above, that exist in a contract. Determining the appropriate accounting requires a full understanding of all of the features and provisions of the contract.

.09 Transfer of Insurance Risk

Inquiry—Why is transfer of insurance risk important under GAAP?

Reply—If a contract does not provide for the indemnification of the insured by the insurer, it is accounted for as a deposit (financing) rather than as insurance as noted in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-20-25-1.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.10 Accounting Guidance for Transfer of Insurance Risk

Inquiry—What GAAP accounting literature provides guidance related to transfer of insurance risk?

Reply—The assessment of transfer of insurance risk requires significant judgment and a complete understanding of the insurance contract and other related contracts between the parties. The greater the number and/or degree of insurance risk limiting features that exist in a contract, the more difficult it becomes to assess whether or not the insurance risk transferred is sufficient to permit the contract to be accounted for as insurance rather than as a deposit.

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-20-25-1 provides the following guidance on insurance contracts that do not provide for indemnification of the insured by the insurer against loss or liability:

To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding entity by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding entity. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding entity is a deposit, it shall be accounted for as such.

FASB ASC 944, *Financial Services—Insurance*, establishes the conditions required for a contract between an insurer and a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. FASB ASC 944-20-15-41 notes:

Unless the condition in paragraph 944-20-15-53 is met, indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of short-duration contracts exists under paragraph 944-20-15-37(a) only if both of the following conditions are met:

- a. Significant insurance risk. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance

contracts. Implicit in this condition is the requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts.

- b. Significant loss. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

FASB ASC 944 looks to the present value of all cash flows between the parties, however characterized, under reasonably possible outcomes in determining whether it is reasonably possible that the reinsurer may realize a significant loss from the contract.

FASB ASC 720-20-25-2 suggests that noninsurance entities look to the risk transfer guidance in FASB ASC 944 and states, in part:

Entities may find the conditions in Section 944-20-15 useful in assessing whether an insurance contract transfers risk.

FASB ASC 944-20-25-1 states that a multiple-year retrospectively rated insurance contract must indemnify the insured as required by FASB ASC 944-20-15-36 to be accounted for as insurance. FASB ASC 944-20 also indicates that there may be certain situations in which the guarantee accounting in accordance with FASB ASC 460, *Guarantees*, is applicable.

FASB ASC 815, *Derivatives and Hedging*, addresses scenarios where there are dual-triggers and includes a number of relevant examples.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.11 Differences Between Retroactive and Prospective Insurance

Inquiry—What are the differences between retroactive and prospective insurance?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-605-05-7 states that for property and casualty insurance: The distinction between prospective and retroactive reinsurance contracts is based on whether the contract reinsures future or past insured events covered by the underlying contracts.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.12 Accounting for Prospective Insurance

Inquiry—How does a noninsurance enterprise account for prospective insurance contracts that qualify for insurance accounting?

Reply—A noninsurance enterprise amortizes the premiums over the contract period in proportion to the amount of insurance protection provided. If an insured loss occurs, and if it is probable that the policy will provide reimbursement for the loss and the amount of the loss can be reasonably estimated, the noninsurance enterprise records a receivable from the insurance enterprise and a recovery of the incurred loss in the income statement. If it is not probable¹ that the policy will provide reimbursement, then the receivable and recovery are not recorded.

¹ According to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, *probable* means that the future event or events are likely to occur.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.13 Accounting for Retroactive Insurance

Inquiry—How does a noninsurance enterprise account for retroactive insurance contracts that qualify for insurance accounting?

Reply—Paragraphs 3–4 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-20-25 state:

Notwithstanding that Topic 944 applies only to insurance entities, purchased retroactive insurance contracts that indemnify the insured shall be accounted for in a manner similar to the manner in which retroactive reinsurance contracts are accounted for under Subtopic 944-605. The guidance in that Subtopic shall be applied, as appropriate, based on the facts and circumstances of the particular transaction. That is, amounts paid for retroactive insurance shall be expensed immediately. Simultaneously, a receivable shall be established for the expected recoveries related to the underlying insured event.

If the receivable established exceeds the amounts paid for the insurance, the resulting gain is deferred. Immediate gain recognition and liability derecognition are not appropriate because the liability has not been extinguished (the entity is not entirely relieved of its obligation). Additionally, the liability incurred as a result of a past insurable event and amounts receivable under the insurance contract do not meet the criteria for offsetting under paragraph 210-20-45-1.

FASB ASC 720-20-35-2 further states:

If the amounts and timing of the insurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the interest method over the estimated period over which the entity expects to recover substantially all amounts due under the terms of the insurance contract. If the amounts and timing of the insurance recoveries cannot be reasonably estimated, then the proportion of actual recoveries to total estimated recoveries shall be used to determine the amount of the amortization.

Paragraphs 22–23 of FASB ASC 944-605-25 state:

Amounts paid for retroactive reinsurance of short-duration contracts that meets the conditions for reinsurance accounting shall 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 exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred.

If the amounts paid for retroactive reinsurance for short-duration contracts exceed the re-corded liabilities relating to the underlying reinsured short-duration contracts, the ceding entity shall increase the related liabilities or reduce the reinsurance receivable or both at the time the reinsurance

contract is entered into, so that the excess is charged to earnings.

FASB ASC 944-605-35-9 further states:

Any gain deferred under paragraph 944-605-25-22 shall be amortized over the estimated remaining settlement period. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the effective interest rate inherent in the amount paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer (the interest method). Otherwise, the proportion of actual recoveries (the recovery method) shall determine the amount of amortization.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.14 Accounting for Multiple-Year Retrospectively Rated Insurance

Inquiry—How does a noninsurance enterprise account for a multiple-year retrospectively rated insurance contract?

Reply—As noted in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-20-05-10, multiple-year retrospectively rated contracts:

include a retrospective rating provision that provides for any of the following based on contract experience:

- a. Changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the noninsurance entity
- b. Changes in the contract's future coverage.

FASB ASC 720-20-05-9 also states, in part:

A critical feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates for each party to the contract future rights and obligations as a result of past events.

FASB ASC 944-20-25-2 also discusses the accounting for retrospective adjustments and states:

For a multiple-year retrospectively rated insurance contract accounted for as insurance, the insurer shall both:

- a. Recognize an asset to the extent that the insured has an obligation to pay cash (or other consideration) to the insurer that would not have been required absent experience under the contract.
- b. Recognize a liability to the extent that any cash (or other consideration) would be payable by the insurer to the insured based on experience to date under the contract.

Paragraphs 3–4 of FASB ASC 944-20-35 further state:

The amount recognized under paragraph 944-20-25-4 in the current period shall be computed, using a with-and-without method, as the difference between the ceding entity's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage.

The amount of premium expense related to impairments of coverage shall be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) shall not be considered in measuring the amount to be recognized.

FASB ASC 944-20-25-4 also further states:

For contracts that meet all of the conditions described in paragraph 944-20-15-55:

- a. The ceding entity shall recognize a liability and the assuming entity shall recognize an asset to the extent that the ceding entity has an obligation to pay cash (or other consideration) to the reinsurer that would not have been required absent experience under the contract (for example, payments that would not have been required if losses had not been experienced).
- b. The ceding entity shall recognize an asset and the assuming entity shall recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming entity to the ceding entity based on experience to date under the contract.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.15 Deposit Accounting

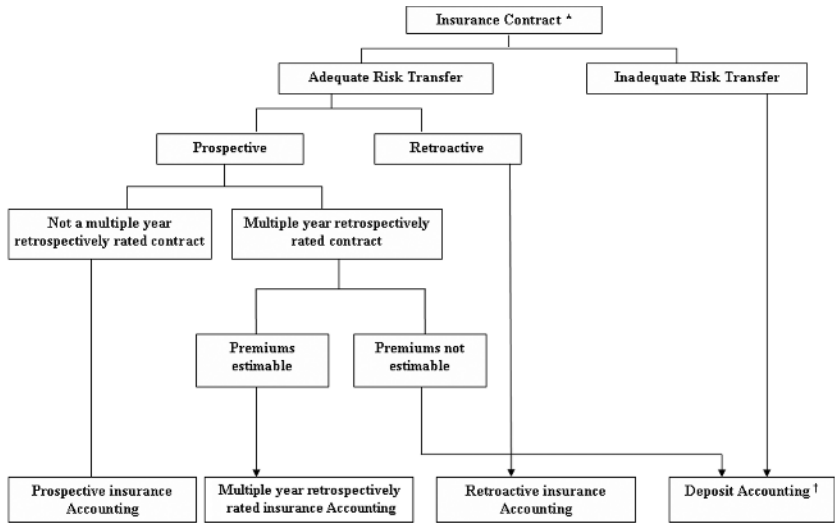
Inquiry—What is deposit accounting?

Reply—Deposit accounting essentially treats the contract as a financing transaction similar to a loan taking into account the time value of money. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 340, *Other Assets and Deferred Costs*, provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.16 Identifying Accounting Model for Insurance Transactions

The accompanying chart depicts the basic decision process in identifying the appropriate accounting model for insurance transactions.



* The insurance model discussed in this series of technical practice aids is based on property and casualty and other short-duration contracts, as defined in Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 944, Financial Services—Insurance*.
† FASB ASC 944-20 should also be considered in determining the accounting for multiple-year retrospectively rated contracts that do not transfer risk.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

Q&A Section 1300**Statement of Cash Flows**

[.01] Reserved

[.02] Reserved

.03 Comparative Statements of Cash Flows

Inquiry—Is it necessary to provide a statement of cash flows for both the current and prior periods if comparative income statements are presented, but only the current balance sheet is presented?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-15-3 states:

A business entity or not-for-profit entity that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

Therefore, if a balance sheet is presented, a statement of cash flows should be presented for both current and prior periods if income statements are presented for such periods.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.04] Reserved

.05 Statement of Cash Flows for Annual Report With Balance Sheet Only

Inquiry—When only a statement of financial position is presented, is it necessary that the auditor's opinion be qualified relative to the omission of the statement of cash flows?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-15-3 states:

A business entity or not-for-profit entity that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

Therefore, when a statement of financial position is not accompanied by a statement of operations, there is no need for presentation of a statement of cash flows, and no comment on the absence of such a statement is necessary.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.06] Reserved

[.07] Reserved

[.08] Reserved

[.09] Reserved

.10 Special Purpose Frameworks

Inquiry—When an entity prepares its financial statements in accordance with a special purpose framework, is a statement of cash flows required?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-15-3 states:

A business entity or not-for-profit entity that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

Paragraph .A17 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), states, in part:

Terms such as *balance sheet*, *statement of financial position*, *statement of income*, *statement of operations*, and *statement of cash flows*, or similar unmodified titles, are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in accordance with GAAP.

Paragraph .A34 of AU-C section 800 states, in part:

Special purpose financial statements may not include a statement of cash flows. If a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, the statement would either conform to the requirements for a GAAP presentation or communicate their substance. As an example, the statement of cash flows might disclose noncash acquisitions through captions on its face.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.11 The Effect of an Error Correction on the Statement of Cash Flows When Single Period Statements Are Presented

Inquiry—How would an error correction be presented in the statement of cash flows if single period statements are presented?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 250-10-45-24 states that "error corrections shall, in single period statements, be reflected as adjustments of the opening balance of retained earnings." A corresponding error correction will normally result in a change in the beginning balance of an asset or liability account. FASB ASC 230-10-50-3 states, in part:

Information about all investing and financing activities of an entity during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be disclosed.

Therefore, the difference in an account between the current balance sheet and that same account in the restated beginning balance sheet (even if not presented) that resulted from the error correction, should be reflected in the

related footnote disclosures and clearly referenced to the statement of cash flows.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.12] Reserved

[.13] Reserved

[.14] Reserved

.15 Presentation of Cash Overdraft on Statement of Cash Flows

Inquiry—A company has accounts at three separate banks. One of the bank accounts is in an overdraft position at year end, thus it is shown as a liability on the balance sheet. Does the company show as cash and cash equivalents on the statement of cash flows only the two accounts with the positive balances or does it show the net cash (the three accounts combined) at the end of the year as its cash and cash equivalents?

Reply—The amount that will be shown on the statement of cash flows is the two accounts with the positive balances. Per Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) ASC 230-10-45-4, "The total amounts of cash and cash equivalents at the beginning and end of the period shall be the same amounts as similarly titled line items or subtotals shown in the statements of financial position . . ." The net change in overdrafts during the period is a financing activity.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.16 Purchase of Inventory Through Direct Financing

Inquiry—An automobile dealer purchases its inventory from a manufacturer which finances purchases through a finance subsidiary. The finance subsidiary pays the manufacturer directly on behalf of the dealer. Cash is not disbursed by the dealer until the automobiles are sold.

Under the provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230, *Statement of Cash Flows*, how should the purchases of inventory be reported by the automobile dealer in the statement of cash flows?

Reply—A statement of cash flows reports an enterprise's cash receipts and cash payments during the period. Transactions that do not involve cash receipts and cash payments should be excluded from the statement of cash flows. Noncash investing and financing transactions should be reported in separate disclosures.

The purchases of inventory described above do not involve a cash flow by the automobile dealer until the automobiles are sold and the dealer pays the finance subsidiary under the financing arrangement. Therefore, only the cash outflows from payments to the finance subsidiary should be included in the body of the statement of cash flows.

Payments made to the finance subsidiary of the manufacturer should be classified as operating cash outflows in accordance with FASB ASC 230-10-45-17, which defines operating cash outflows to include principal payments on accounts and notes payable to suppliers for goods acquired for resale.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.17 Omission of Reconciliation of Net Income to Cash Flow From Operations

Inquiry—When an accountant is requested to compile financial statements that omit substantially all of the disclosures required by accounting principles generally accepted in the United States of America in accordance with paragraph .20 of AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*), would the omission of the schedule, "reconciliation of net income to net cash flow from operating activities" required by the direct method of reporting cash flows under FASB ASC 230 be considered a departure from accounting principles generally accepted in the United States of America?

Reply—Yes. Under the direct method of reporting net cash flows from operating activities, the separate schedule reconciling net income to net cash flow from operating activities is a required part of the cash flow statement. If the schedule is omitted, the accountant should modify his compilation report to disclose a departure from accounting principles generally accepted in the United States of America in accordance with paragraphs .27–.29 of AR section 80.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

[.18] Reserved**.19 Classification of Payments on Equipment Finance Note**

Inquiry—Under the provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-50-3, noncash investing and financing transactions are to be disclosed in related narrative form or summarized in a schedule. An example of a transaction of this type would be an acquisition of equipment in a transaction in which an enterprise borrows money from a financial institution for the purchase of equipment and the financial institution remits the money directly to the vendor. In a transaction of this nature, should the payments of principal be presented as an outflow in the financing or investing section of the cash flow statement?

Reply—Payments on the aforementioned notes would be recorded as financing outflows per FASB ASC 230-10-45-15(b).

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.20 Direct vs. Indirect Method for Statement of Cash Flows

Inquiry—A company has decided to present its statement of cash flows using the direct method for the current year although the indirect method was used in the prior year. Would this change require an emphasis-of-matter paragraph noting a lack of consistency in the financial statements?

Reply—No. A change in the presentation for the statement of cash flows from the indirect to direct method (or vice versa) is considered a change in classification rather than a consistency problem. If the statement of cash flows is presented for the prior period, it should be restated using the direct method approach for comparative purposes. In addition, disclosure should be made indicating the prior period restatement.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.21 Presentation of Financing Transaction on Statement of Cash Flows

Inquiry—A buyer contracts to purchase real estate. The lender gives the buyer a check made payable to the buyer for a loan to purchase the property. The buyer in turn endorses the check over to the seller. How should this financing transaction be presented on the buyer's statement of cash flows?

Reply—This transaction should be treated as a cash receipt by the buyer since the buyer was named as payee on the check. The amount of the check should be reported on the statement of cash flows even though the buyer did not convert the check to currency or deposit it in his or her bank account. The cash receipt belongs to the payee named on the check. The buyer should present the amount of the check as "Proceeds From Borrowings" as a cash inflow from financing transactions and "Purchase of Real Estate" as a cash outflow from investing activities.

.22 Negative Amortization of Long-Term Debt in Cash Flows Statement

Inquiry—The cash repayments on a long-term loan are less than the interest expense for the period. The amount of the interest expense not paid becomes part of the principal balance (negative amortization). How should the negative amortization be shown on the cash flows statement?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-45-28(a) indicates:

Adjustments to [reconcile] net income to determine net cash flow from operating activities shall reflect accruals for interest earned but not received and interest incurred but not paid.

The negative amortization should therefore be treated as an adjustment to net income to remove the effect of this noncash expense. Disclosure should also be considered.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

Q&A Section 1400***Consolidated Financial Statements*****[.01] Reserved****.02 Consolidation of Corporation and Proprietorship**

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

Reply—This answer assumes that 100 percent of the corporation capital stock is owned by the proprietorship.

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

[Revised, April 2010.]

[.03] Reserved**[.04] Reserved****[.05] Reserved****.06 Combined and Separate Financial Statements**

Inquiry—Company A and Company B are new car dealers with A selling an American made car and B selling a foreign made car. One individual owns 100 percent of the outstanding stock of both companies.

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

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

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

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

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810-10-55-1B states, in part:

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

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

Unfortunately, FASB ASC 810, *Consolidation*, makes no statement as to appropriate presentation of the stockholder's equity section of a combined balance sheet. Appropriate disclosure, therefore, may depend upon the circumstances. Either on the statement of financial position, or in a note, there should be disclosure for each company of their number of shares of stock that are authorized and outstanding, and the par value. While under some circumstances it might not be necessary to disclose the allocation of retained earnings between the two companies, other circumstances may exist under which such disclosure would be required—for example, if the losses of either company have been so severe that an insolvent condition might be anticipated.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.07 Reporting on Company Where Option to Acquire Control Exists

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

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

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

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

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

[.08] Reserved

[.09] Reserved

[.10] Reserved

[.11] Reserved

[.12] Reserved

[.13] Reserved

[.14] Reserved

[.15] Reserved

[.16] Reserved

[.17] Reserved

[.18] Reserved

[.19] Reserved

[.20] Reserved

[.21] Reserved

.22 Intervening Intercompany Transactions Between Subsidiary's and Parent's Year-End

Inquiry—A parent company has a December 31 year-end and its wholly owned subsidiary has a November 30 year-end. The two companies generally have substantial intercompany sales and purchases which are recorded by each company as they occur. The parent uses the subsidiary's November 30 year-end statement to prepare the consolidated financial statements.

The intervening intercompany transactions, which occur between December 1 and December 31, create intercompany account balances which do not eliminate upon consolidation due to the difference in year-ends of the parent and its subsidiary. How should these intervening transactions be accounted for in the consolidated financial statements?

Reply—In discussing differences in fiscal periods, Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810-10-45-12 states, "if the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's financial statements for its fiscal period; if this is done, recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations."

When a subsidiary's fiscal year differs from that of the parent, intercompany accounts may not agree. Transactions in the interval between the subsidiary's year-end and the parent's year-end must be analyzed and appropriate consolidation entries prepared.

A practical approach to preparing these consolidation entries would be to reverse the intervening intercompany transactions in the parent company's accounts but not in the subsidiary's accounts. A summary of these intervening transactions could then be disclosed in a note to the consolidated financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.23 Conforming Subsidiary's Inventory Pricing Method to Its Parent Company's Method

Inquiry—A parent company uses the first-in, first-out (FIFO) cost assumption to price its inventory, while its subsidiary uses the last-in, first-out (LIFO) cost assumption to price its inventory. Must the subsidiary's inventory method be changed to conform to the FIFO method used by its parent company in consolidated financial statements?

Reply—There is no requirement under generally accepted accounting principles for the subsidiary to conform its inventory pricing method with the parent company's method. Consolidated statements may be presented with the subsidiary using LIFO and the parent using FIFO. Also, separate subsidiary only statements may be presented on the LIFO basis.

[.24] Reserved**.25 Issuance of Parent Company Only Financial Statements**

Inquiry—Generally accepted accounting principles preclude preparation of parent company financial statements for issuance to stockholders as the financial statements of the primary reporting entity. Are there any circumstances under which parent company financial statements may still be prepared?

Reply—Yes. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810-10-45-11 states: "In some cases parent entity statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent. Consolidating statements, in which one column is used for the parent entity and other columns for particular subsidiaries or groups of subsidiaries often are an effective means of presenting the pertinent information."

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.26 Consolidated Versus Combined Financial Statements

Inquiry—S Corporation has 2000 common shares and 1000 preferred shares outstanding. The preferred shareholders have the same rights as the common shareholders, except the right to vote. Of the 2000 common shares outstanding, 1000 shares are owned by P Corporation and 1000 shares are owned by I (an individual) who also owns all of the outstanding common shares of P Corporation. The preferred shares of S Corporation are owned by an outside party. Should P Corporation consolidate S Corporation for financial reporting purposes?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810-10-05-6 states that to "justify the preparation of consolidated financial statements, the controlling financial interest shall rest directly or indirectly in one of the entities included in the consolidation." In this situation P does not control S directly or indirectly and therefore consolidation is not appropriate. Combined financial statements could be presented if the circumstances are such that combined financial statements of S Corporation and P Corporation are more meaningful than separate financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.27 Subsidiary Financial Statements

Inquiry—Generally accepted accounting principles indicate that "consolidated rather than parent-company financial statements are the appropriate general-purpose financial statements." May subsidiary-only financial statements be issued without consolidated financial statements?

Reply—Yes. Generally accepted accounting principles do not preclude issuance of subsidiary-only statements. Care should be taken to include all disclosures required by Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) SC 740-10-50-17, FASB ASC 850, *Related Party Disclosures*, and other relevant pronouncements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.28] Reserved**.29 Consolidated Versus Combined Financial Statements Under FASB ASC 810, Consolidation**

Inquiry—If a reporting entity is the primary beneficiary of a variable interest entity (VIE) under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810, *Consolidation*, would it be appropriate to issue combined financial statements rather than consolidated financial statements?

Reply—No. FASB ASC 810-10-05-6 permits combined financial statements in certain situations in which consolidated financial statements are not required. However, FASB ASC 810-10-25-38 states that "an entity shall consolidate a variable interest entity if that entity has a variable interest (or combination of variable interests) that will absorb a majority of the variable interest entity's expected losses, receive a majority of the variable interest entity's expected residual returns, or both." Furthermore, the starting point for the preparation of combined financial statements is two or more sets of financial statements that are prepared in accordance with GAAP; in the case of a primary beneficiary of a VIE, financial statements prepared in accordance with GAAP would be consolidated financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.30 Stand-Alone Financial Statements of a Variable Interest Entity

Inquiry—Regarding Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810, *Consolidation*, is it appropriate to present stand-alone financial statements of a variable interest entity (VIE)?

Reply—FASB ASC 810 does not specifically address this issue. Subsidiary-only financial statements are appropriate under generally accepted accounting principles. By extension, it may be appropriate to present stand-alone financial statements of a VIE.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.31 GAAP Departure for FASB ASC 810

Inquiry—If a reporting entity is the primary beneficiary of a variable interest entity under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810, *Consolidation*, what are the implications

for the auditors' report if the reporting entity does not consolidate the variable interest entity?

Reply—AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), addresses the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. Paragraph .07a of AU-C section 705 states that when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are materially misstated, the auditor should modify the opinion in the auditor's report.

As paragraph .02 of AU-C section 705 explains, the decision regarding which type of modified opinion (a qualified opinion, an adverse opinion, and a disclaimer of opinion) is appropriate depends upon the following:

- a. The nature of the matter giving rise to the modification (that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated)
- b. The auditor's professional judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements

If an auditor concludes that a qualified opinion is appropriate, he or she should disclose the GAAP departure in a separate paragraph headed "Basis for Qualified Opinion" preceding the opinion paragraph of the report. Furthermore, the opinion paragraph of the report should include the appropriate qualifying language and a reference to the basis for qualified opinion paragraph. The basis for modification paragraph should include a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor should so state in the basis for modification paragraph. If such disclosures are made in a note to the financial statements, the basis for modified opinion paragraph may be shortened by referring to it.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.32 Parent-Only Financial Statements and Relationship to GAAP

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810, *Consolidation*, addresses parent company financial statements. If consolidation is required under generally accepted accounting principles (GAAP), are there any circumstances in which an entity may prepare parent company-only financial statements without preparing related consolidated financial statements and say that the parent company-only financial statements are in accordance with GAAP?

Reply—No. FASB ASC 810-10-10-1 notes the presumption in GAAP that consolidated financial statements are more meaningful than parent entity-only financial statements. FASB ASC 810-10-15-10 states that all majority-owned subsidiaries shall be consolidated, with few exceptions. FASB ASC 810-10-45-11 adds that parent company financial statements may be needed in addition to consolidated financial statements, but it does not suggest that parent

company financial statements may be prepared in place of consolidated financial statements.

For example, if, as a condition of a legal or regulatory agreement, an entity is required to submit "restricted" or "special use" parent-only financial statements without related consolidated financial statements, the restricted or special use parent-only financial statements are not in accordance with GAAP.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.33] Reserved

Q&A Section 1500***Financial Statements Prepared in Accordance With a Special Purpose Framework***

For nonauthoritative guidance regarding financial statements prepared in accordance with the cash- or tax-basis of accounting, consult the AICPA publication *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements*. That practice aid alerts the reader to some of the most frequently-encountered issues faced by accounting professionals in dealing with cash- and tax-basis financial statements and provides suggestions and insight into how these issues are resolved in practice. In addition, the AICPA has published a separate practice aid, *Applying OCBOA in State and Local Government Financial Statements*. To order these publications, call the AICPA at 1.888.777.7077 or visit www.cpa2biz.com.

[.01] Reserved

[.02] Reserved

[.03] Reserved

.04 Terminology for Special Purpose Financial Statements

The Clarification and Convergence project of the AICPA Accounting and Review Services Committee is currently underway. Upon the completion of this project, this Inquiry and Reply will be conformed to include references to the pertinent clarified AICPA Statements on Standards for Accounting and Review Services that are expected to be issued as a result of the project.

Inquiry—(1) If an entity prepares financial statements in accordance with a special purpose framework, may GAAP financial statement titles be used?

(2) What should be the caption for "net income" or "net loss," and may the corporation use "retained earnings"?

Reply—(1) No. Paragraph .A17 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), explains that unmodified GAAP financial statement titles are not acceptable for use in special purpose financial statements. The paragraph contains a few examples of appropriate financial statement titles (for example, *Statement of Assets and Liabilities Arising from Cash Transactions* and *Statement of Income—Regulatory Basis*). However, the examples presented in the authoritative literature were not meant to be all-inclusive and are not the only acceptable titles. Equally acceptable titles would be *Balance Sheet—Cash Basis* or *Statement of Operations—Income Tax Basis*. The selection of specific financial statement titles is a matter of judgment; any modified title would fulfill the requirements of AU-C section 800 as long as it is clear that the financial statements are not prepared in accordance with GAAP.

(2) The authoritative literature is silent regarding the captions to be used within special purpose financial statements. Therefore, there is no requirement to modify standard GAAP financial statement captions in special purpose financial statements. If modifications are desired, common examples for cash basis financial statements are *Excess of revenue collected over expenses paid*, *Excess of expenses paid over revenue collected*, and *Accumulated excess of revenue over expenses paid*. For tax-basis financial statements, acceptable modifications include *Retained earnings—income tax basis* and *Net income—tax basis*.

[Amended, February 1995; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.05] Reserved

[.06] Reserved

.07 Disclosure Concerning Subsequent Events in Special Purpose Financial Statements

Inquiry—FASB Accounting Standards Codification (ASC) 855, *Subsequent Events*, sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. FASB ASC 855 also requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date on which the financial statements were issued or were available to be issued. Should full disclosure financial statements prepared in accordance with a special purpose framework contain the disclosures set forth in FASB ASC 855?

Reply—Paragraph .A26 of AR-C section 80, *Compilation Engagements* (AICPA, *Professional Standards*), and paragraph A80 of AR-C section 90, *Review of Financial Statements* (AICPA, *Professional Standards*), state "financial statements prepared when applying a special purpose framework^[1] are not considered appropriate in form unless the financial statements include informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or are similar to, those in financial statements prepared in accordance with GAAP." Paragraph .A20 of AU-C section 800 states, in part, "when the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, informative disclosures similar to those required by GAAP are necessary to achieve fair presentation."

Therefore, the date through which an entity has evaluated subsequent events and the basis for that date should be disclosed. Furthermore, some non-recognized subsequent events are of such a nature that disclosure is required to keep the financial statements prepared from being misleading. Such events should be disclosed following the guidance in FASB ASC 855.

[Issue Date: June 2009; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126; Revised, March 2016, to reflect conforming changes necessary due to the issuance of SSARS No. 21.]

^[1] [Footnote deleted to reflect conforming changes necessary due to the issuance of SSARS No. 21.]

Q&A Section 1600***Personal Financial Statements***

[.01] Reserved

[.02] Reserved

.03 Social Security Benefits—Personal Financial Statements

Inquiry—Do social security benefits to be received based on the future life expectancy of an individual qualify as an asset in personal financial statements?

Reply—No. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 274, *Personal Financial Statements*, indicates that nonforfeitable rights to receive future sums must meet certain criteria to be accounted for as assets. One of these criteria is that the rights must not be contingent on the individual's life expectancy or the occurrence of a particular event, such as disability or death. In this example, because the social security benefits are contingent on the individual's life expectancy, they do not qualify as a recognizable asset for the personal financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.04 Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 274, *Personal Financial Statements*, states that personal financial statements should present assets at their estimated current values and liabilities at their estimated current amounts at the date of the financial statements. FASB ASC 274 also defines estimated current values and current amounts.

Are the definitions of *current values* (assets) and *current amounts* (liabilities) for personal financial statements meant to be the same as *fair value*, as defined in FASB ASC 820, *Fair Value Measurements and Disclosures*?

Reply—No. FASB ASC 820 did not contemplate the reporting of personal financial statements, and FASB did not amend the definitions of estimated current values and current amounts for personal financial statements as part of its codification process.

[Issue Date: June 2009.]

Q&A Section 1700

Prospective Financial Statements

[.01] Reserved

Q&A Section 1800**Notes to Financial Statements**

[.01] Reserved

[.02] Reserved

.03 Disclosure of Change in Fiscal Year

Inquiry—What disclosure in the financial statements is necessary when a company changes its fiscal year?

Reply—Generally accepted accounting principles (GAAP) do not specifically require disclosure of a change in the fiscal year. However, disclosure of such a change is generally considered necessary to make the financial statements meaningful to users.

[.04] Reserved

.05 Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures, to Certain Financial Instruments

Inquiry—Do the fair value measurement principles and disclosure requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures*, apply to financial instruments that are not recognized at fair value in the statement of financial position, but for which fair value is required to be disclosed in the notes to financial statements in accordance with paragraphs 10–19 of FASB ASC 825-10-50?

Reply—The measurement principles of FASB ASC 820 apply when determining for disclosure purposes the fair value of financial instruments that are not recognized at fair value in the statement of financial position. FASB ASC 820-10-15-1, which establishes the scope of FASB ASC 820, provides that "Except as noted below, this Topic applies when another Topic requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements)." The exceptions relate to (a) share-based payment transactions, (b) FASB ASC sections, subtopics, or topics that require or permit measurements that are similar to fair value but that are not intended to measure fair value, and (c) certain fair value measurements for purposes of lease classification or measurement in accordance with FASB ASC 840.

In addition, certain disclosure requirements of FASB ASC 820 apply to financial instruments for which fair value is only disclosed. Specifically, FASB ASC 820-10-50-2E provides that for each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed,

a reporting entity shall disclose the information required by paragraph 820-10-50-2(b), (bbb), and (h). However, a reporting entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy required by paragraph 820-10-50-2 (bbb). For such assets and liabilities, a reporting entity does not need to provide the other disclosures required by this Topic.

[Issue Date: May 2010; Revised, April 2014, to reflect conforming changes necessary due to revisions to FASB ASC.]

.06 Applicability of Fair Value Disclosure Requirements in FASB ASC 820 to Financial Statements Prepared in Accordance With a Special Purpose Framework

Inquiry—If management prepares an entity's financial statements in accordance with a special purpose framework, and those financial statements include accounts measured at fair value, what is the auditor's responsibility with respect to fair value disclosure requirements in FASB ASC 820-10-50?

Reply—As indicated in paragraph .19 of AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*), and paragraph .32 of AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*), "financial statements prepared in accordance with an OCBOA¹ are not considered appropriate in form unless the financial statements include informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or are similar to, those in financial statements prepared in accordance with GAAP." Additionally, paragraph .A20 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), states "when the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, informative disclosures similar to those required by GAAP are necessary to achieve fair presentation."

Therefore, if special purpose financial statements reflect assets or liabilities measured at fair value in accordance with FASB ASC 820, the accountant/auditor should consider whether the financial statements (including the accompanying notes) include the fair value disclosure requirements of FASB ASC 820 as appropriate for the basis of accounting used.

[Issue Date: June 2010; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

¹ The cash, tax, and regulatory bases of accounting are commonly referred to as *other comprehensive bases of accounting* (OCBOA). [Footnote added, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Q&A Section 1900***Interim Financial Information*****.01 Condensed Interim Financial Reporting by Nonissuers**

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 270, *Interim Reporting*, provides accounting and disclosure guidance relating to *recognition and measurement* in interim financial information (including condensed interim financial statements). FASB ASC 270 does not provide a reporting framework for condensed interim financial statements—that is, minimum requirements for the *form and content* of condensed interim financial statements. Article 10 of Securities and Exchange Commission (SEC) Regulation S-X provides guidance on the form and content of condensed interim financial statements of issuers. When preparing condensed interim financial statements, because specific guidance with respect to form and content is absent, may nonissuers apply Article 10 of SEC Regulation S-X in addition to complying with FASB ASC 270 with respect to recognition and measurement?

Reply—Yes. In the absence of established accounting principles for form and content in preparing condensed interim financial statements, nonissuers may analogize to the guidance in Article 10 of SEC Regulation S-X.

Preparers should keep in mind that the purpose of *condensed* interim financial statements is to provide an update to users of the entity's annual financial statements prepared in accordance with generally accepted accounting principles. Article 10 of SEC Regulation S-X also has this premise. Therefore, to avoid being considered misleading,

- such condensed interim financial statements would include a note that the financial information should be read in conjunction with the entity's latest annual financial statements, and
- the entity's latest annual financial statements would either accompany such condensed interim financial statements or be made readily available by the entity. The financial statements are deemed to be readily available if a user can obtain the financial statements without any further action by the entity (for example, financial statements on an entity's Web site may be considered readily available, but being available upon request is not considered readily available).

[Issue Date: January 2009; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

